Supreme Court of the United States

OCTOBER TERM, 1962

No. 618

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

vs.

CAPITAL GAINS RESEARCH BUREAU, INC., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

INDEX

[fol. 1]

IN THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

Civil Action File No. 60-4526

[File Endorsement Omitted]

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

-against-

CAPITAL GAINS RESEARCH BUREAU, INC.
HARRY P. SCHWARZMANN, DEFENDANTS

COMPLAINT—filed November 17, 1960

1. It appears to the plaintiff that the defendants have engaged and are about to engage in acts and practices which constitute and will constitute violations of Section 206(1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6(1) and (2), and the Securities and Exchange Commission brings this action to enjoin such acts and practices.

2. This action arises under Section 209(e) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-9(e) as hereinafter more fully appears.

3. This Court has jurisdiction of this action under Section 214 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-14.

4. The defendant Capital Gains Research Bureau, Inc. is now and has been since on or about July 1959 registered [fol. 2] as an investment adviser pursuant to Section 203 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3. The defendant Harry P. Schwarzmann is president, director and sole stockholder of said Capital Gains Research Bureau, Inc.

5. The defendant Capital Gains Research Bureau, Inc. is a corporation duly constituted and acting under the laws of the State of New York and maintains its place of business in Larchmont, Westchester County, New York.

6. The defendant Harry P. Schwarzmann resides at Hampshire House, Larchmont, Westchester County, New York.

7. Since on or about January 1, 1960 to the present, the defendant, Capital Gains Research Bureau, Inc., an investment adviser, by use of the mails or the means or instrumentalities of interstate commerce, directly or indirectly, has employed devices, schemes and artifices to defraud clients and prospective clients in that said defendant mailed and caused to be otherwise distributed to its clients, prospective clients and others, various bulletins, news items and other writings suggesting and recommending the purchase, retention or disposition of various securities at a time and when said defendant did not disclose in writing or otherwise the following material facts:

(a) That within a very short period prior to the distribution of a recommendation for purchase of se-
[fol. 3] curities, said defendant had effected purchases of said securities so recommended for its own account;

(b) That thereafter said defendant intended to sell said securities so recommended within a very short period after the distribution of said recommendation and did in fact sell said securities;

(c) That said defendant within a very short period prior to the distribution of a recommendation to dispose of securities, had effected short sales for its own account of said securities so recommended to be disposed of;

(d) That thereafter said defendant intended to purchase said securities to cover its short sales and did in fact purchase said securities;

(e) That within a very short period prior to the distribution of a recommendation for purchase or disposition of securities to its clients and prospective clients said defendant had effected the purchase for its own account of puts and calls for the securities so recommended.

[fol. 4] 8. Since on or about January 1, 1960, defendant, Capital Gains Research Bureau, Inc., has engaged in transactions, practices and courses of business which

operate and have operated as a fraud and deceit upon clients and prospective clients by engaging in the acts and practices hereinabove set forth in paragraph 7.

9. The defendant Harry P. Schwarzmann, as director, president and sole stockholder of defendant Capital Gains Research Bureau, Inc., commanded, induced, procured, abetted and aided the acts and practices hereinabove set forth in paragraphs 7 and 8.

10. The defendants and each of them will, unless enjoined, continue to engage in the acts and practices set forth in this complaint.

WHEREFORE the plaintiff demands a temporary restraining order, preliminary injunction and final injunction:

1. Enjoining the defendants Capital Gains Research Bureau, Inc. and Harry P. Schwarzmann, their agents, servants, employees, attorneys and assigns, and each of them, while the said Capital Gains Research Bureau, Inc. is an investment adviser, directly and indirectly, by the use of the mails or any means or instrumentalities of interstate commerce from:

(a) Employing any device, scheme or artifice to defraud
[fol. 5] any client or prospective client by failing to disclose the material facts concerning

(1) The purchase by defendant, Capital Gains Research Bureau, Inc., of securities within a very short period prior to the distribution of a recommendation by said defendant to is clients and prospective clients for purchase of said securities;

(2) The intent to sell and the sale of said securities by said defendant so recommended to be purchased within a very short period after distribution of said recommendation to its clients and prospective clients;

(3) Effecting of short sales by said defendant within a very short period prior to the distribution of a recommendation by said defendant to its clients and prospective clients to dispose of said securities;

(4) The intent of said defendant to purchase and [fol. 6] the purchase of said securities to cover its short sales;

(5) The purchase by said defendant for its own account of puts and calls for securities within a very short period prior to the distribution of a recommendation to its clients and prospective clients for purchase or disposition of said securities.

(b) Engaging in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client by failing to disclose the material facts concerning the matters set forth in demand 1(a) hereof.

/s/ Paul Windels, Jr.
Regional Administrator

/s/ Henry R. Bright
Attorney

[fol. 7]

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

Civil Action File No. 60 CIV 4526

[File Endorsement Omitted]

[Title Omitted]

ORDER TO SHOW CAUSE AND TEMPORARY RESTRAINING ORDER—November 17, 1960

On motion of the plaintiff herein, and upon the complaint in this action and the affidavit of John R. Steinert annexed hereto, and it appearing satisfactorily that the defendants herein, pending determination of this action, unless restrained, will, by the use of the mails or the means or instrumentalities of interstate commerce continue to employ devices, schemes and artifices to defraud clients and prospective clients and to engage in transactions, practices and courses of business which operate and have operated as a fraud and deceit upon clients and prospective clients in that since on or about January 1, 1960 to the present the defendant Capital Gains Research Bureau, Inc., an investment adviser, by use of the mails or the means or instrumentalities of interstate commerce directly or indirectly has employed devices, schemes and artifices to defraud clients and prospective clients and has engaged in transactions, practices and courses of business which operate and have operated as a fraud and deceit upon clients and prospective clients by mailing and dis- [fol. 8] tributing to clients, prospective clients and others, various bulletins, news items and other writings suggesting and recommending the purchase, retention or disposition of various securities at a time and when said defendant did not disclose in writing or otherwise the following material facts:

(a) That within a very short period prior to the distribution of a recommendation for purchase of securities, said defendant had effected purchases of said securities so recommended for its own account;

(b) That thereafter said defendant intended to sell said securities so recommended within a very short period after the distribution of said recommendation and did in fact sell said securities;

(c) That said defendant within a very short period prior to the distribution of a recommendation to dispose of securities, had effected short sales for its own account of said securities so recommended to be disposed of;

(d) That thereafter said defendant intended to purchase said securities to cover its short sales and did in fact purchase said securities;

[fol. 9] (e) That within a very short period prior to the distribution of a recommendation for purchase or disposition of securities to its clients and prospective clients said defendant had effected the purchase for its own account of puts and calls for the securities so recommended; it is hereby

Ordered that the defendants show cause at 10 o'clock in the forenoon of November 22nd, 1960 at Room 506 in the United States Court House, Foley Square, City, County and State of New York, or as soon thereafter as counsel can be heard, why a preliminary injunction, pursuant to Rule 65 of the Federal Rules of Civil Practice, should not be granted for relief sought by the plaintiff herein, and that representatives of the plaintiff herein, after the filing of this order and annexed affidavit with the clerk of this Court, shall serve conformed copies thereof upon the defendants at the address set forth in the complaint in this action on or before 5 PM November 18, 1960 before 5 o'clock in the afternoon on said date.

On motion of the plaintiff and upon the complaint herein and annexed affidavit and it further satisfactorily appearing that unless the defendants are restrained from continuing the acts alleged in the complaint immediate and irreparable injury, loss and damage may result to clients [fol. 10] or or prospective clients of defendant Capital Gains Research Bureau, Inc. in that such persons may be induced by the defendants to purchase or dispose of securities in violation of Section 206(1) and (2) of the

Investment Advisers Act of 1940, 15 U.S.C. 80b-6(1) and (2), it is hereby

ORDERED that, pending the determination of this Motion for Preliminary Injunction herein, the defendants, their officers, agents, attorneys, employees, successors and assigns and each of them, and all persons acting in concert or participation with them be, and they are hereby restrained from:

(a) Employing any device, scheme or artifice to defraud any client or prospective client by failing to disclose the material facts concerning

(1) The purchase by defendant, Capital Gains Research Bureau, Inc. of securities within a very short period prior to the distribution of a recommendation by said defendant to its clients and prospective clients for purchase of said securities;

(2) The intent to sell and the sale of said securities by said defendant so recommended to be [fol. 11] purchased within a very short period after distribution of said recommendation to its clients and prospective clients;

(3) Effecting of short sales by said defendant within a very short period prior to the distribution of a recommendation by said defendant to its clients and prospective clients to dispose of said securities;

(4) The intent of said defendant to purchase and the purchase of said securities to cover its short sales;

(5) The purchase by said defendant for its own account of puts and calls for securities within a very short period prior to the distribution of a recommendation to its clients and prospective clients for purchase or disposition of said securities.

(b) Engaging in any transaction, practice and course of business which operates as a fraud or deceit

[fil.12] upon any client or prospective client by failing to disclose the material facts concerning the matters set forth hereinabove in Items (1) through (5).

/s/ Alexander Bicks
United States District Judge

Dated: New York, N. Y.
November 17, 1960
At 2:00 o'clock P.M.

[fol. 13] AFFIDAVIT OF JOHN R. STEINERT

STATE OF NEW YORK)
) ss.
COUNTY OF NEW YORK)

JOHN R. STEINERT, being duly sworn, deposes and says:

I am employed as a Securities Investigator in the New York Regional Office of the Securities and Exchange Commission.

On or about November 14, 1960, I was assigned to conduct an investigation into the activities of the Capital Gains Research Bureau, Inc.; and, in this connection, also to supervise other securities investigators who were assigned to this matter. In this connection, I collected from various broker-dealers transcripts of securities accounts maintained by Capital Gains Research Bureau, Inc., and examined similar transcripts obtained by other investigators. I also analyzed the trading data reflected in these accounts; examined various literature distributed by Capital Gains Research Bureau, Inc.; and participated in the examination on November 16, 1960 of Harry P. Schwarzmann. The following is furnished on information and belief on the basis of the aforesaid investigation:

Capital Gains Research Bureau, Inc. is a New York Corporation formed in July 1959 as a successor to a sole proprietorship of the same name. It is registered with the [fol. 14] Securities and Exchange Commission as an investment adviser under the Investment Advisers Act. The sole stockholder of the corporation is Harry P. Schwarzmann, who serves as its president.

Capital Gains Research Bureau, Inc., as an investment adviser, is engaged in the business of distributing to subscribers, at a fee of $24.00 per annum, a periodic bulletin which is termed "Facts on the Funds," which for the most part explores changes effected in the portfolio of Mutual Funds. It also distributes to subscribers at $18.00 per annum bulletins captioned "A Capital Gains Report," in which it undertakes to analyze a specific security with a recommendation as to the advisability of a purchase or sale. There are about 20,000 subscribers to the "Facts on

Funds" bulletin and about 5,000 subscribers to the "Capital Gains Report." The latter report, however, is very frequently distributed to the "Facts on Funds" subscribers. Additionally, the "Capital Gains Report," is frequently distributed to an unknown number of a mailing list consisting of about 100,000 non-subscribers. Capital Gains Research Bureau, Inc. rents and otherwise obtains other mailing lists for the purpose of distributing its literature.

On or about March 18, 1960, Capital Gains Research Bureau, Inc. widely circulated a report on Continental Insurance Company, in which it recommended purchase of these shares. On March 15, 1960, or 3 days before the [fol. 15] mailing date of this report, Schwarzmann caused Capital Gains Research Bureau to purchase through a broker-dealer 500 shares of Continental Insurance at prices of \$47¾ and \$47⅞ per share. On March 29, 1960 he caused these shares to be sold at \$50⅛. Annexed hereto is Exhibit "A", which shows a table reflecting with respect to Continental Insurance Company stock, the high, low, and closing prices on the New York Stock Exchange, together with a daily volume for the period March 15, 1960 through March 29, 1960. This shows that the volume of transactions in this stock increased considerably following distribution of the above-mentioned report, accompanied by an increase in the market price for the stock. It also reflects the dates upon which Capital Gains purchased and sold Continental Insurance stock.

During the period May 13, 1960, to and including May 20, 1960, Schwarzmann caused Capital Research to purchase through a broker-dealer an aggregate of 5,300 shares of United Fruit Company stock for an aggregate cost of \$117,114.00. On May 27, 1960, Capital Research widely distributed a report recommending purchase of United Fruit stock; and thereafter in the period June 6, 1960 through June 10, 1960, Schwarzmann caused Capital Research to sell the 5,300 shares of United Fruit for an aggregate price of \$127,840.00, reflecting a profit of \$10,725.00. It will be seen from Exhibit "B", annexed hereto, the high, low and closing prices of United Fruit, together with the volume on the New York Stock Ex-

change, for the period May 13, 1960, the date when Capital Research commenced purchasing this stock, to June 10, 1960, when that firm completed the sales of this stock. [fol. 16] It also shows the pertinent trading data on the date when the report on United Fruit was mailed to subscribers; and also shows that immediately following the date of such mailing the volume on the Exchange in United Fruit stock increased substantially with the price of the stock moving upwards.

On or about July 15, 1960, Schwarzmann caused Capital Gains to widely distribute a report on Creole Petroleum Corporation. It expressed optimistic views with respect to the stock of that corporation. On July 5, 1960 and July 14, 1960, ~~or~~ prior to the mailing of this report, Schwarzmann caused Capital Research to purchase through two brokers an aggregate of 2,000 shares of Creole Petroleum, of which 1,500 shares were purchased at prices between \$25¼ and \$25⅝, and 500 shares were purchased at \$28¾. Subsequently, on July 20, 21 and 22, 1960, these shares were sold at a price range between \$29 and \$27⅛. Exhibit "C", annexed hereto, shows pertinent trading data with respect to Creole Petroleum during the period July 5, 1960 through July 22, 1960, with the appropriate notations of the dates on which Capital Research mailed the report on Creole Petroleum, and the dates when it effected purchases and sales of that stock.

On August 6, 1960, Schwarzmann caused Capital Gains to effect a purchase of 600 shares of Hart, Schaffner & Marx stock at \$23.00 per share. On August 12, 1960, Capital Gains issued a report recommending the purchase [fol. 17] of Hart, Schaffner & Marx stock. On August 18, 1960, Capital Gains sold 300 shares of Hart, Schaffner & Marx stock at \$25¼; and on August 22, 1960, Capital Gains sold 300 shares at \$24⅞, resulting in a profit of \$837.00. Annexed hereto is Exhibit "D", which shows the high, low and closing prices of Hart, Schaffner & Marx stock, and also the daily trading volume, indicating the dates of purchase and sale by Capital Research, the amount of shares purchased and sold on these dates; also including the date the report was mailed.

On October 14, 1960, the Corporation mailed a report to its subscribers and others entitled "A Study of Rela-

tive Value—Chock Full O'Nuts . . . Now Selling at $70 Frank G. Shattuck Co. (Schrafft's . . . Now Selling at $16). The basic aspect of this report is pointing out a comparative value of Frank G. Shattuck Company stock versus Chock Full O'Nuts stock. On October 4, 1960, Schwarzmann caused Capital Gains Research Bureau, Inc. to sell short 500 shares of Chock Full O'Nuts stock at prices ranging from $68¾ to $69.00 per share for a net total of $34,208.00. On October 24, 1960, 10 days after the letter had been mailed, Schwarzmann caused Capital Gains Research Bureau, Inc. to cover the 500 shares at prices of $62.00 for 100 shares and $62.50 for 400 shares for a net cost of $31,426.00, resulting in a profit of $2,782.00.

[fol. 18] In addition to the actual short sales as listed above, Schwarzmann caused Capital Gains Research Bureau to purchase the following "puts" on Chock Full O'Nuts stock: October 4, 1960, 5 "puts" of 100 shares each at $69¼ which expire on January 3, 1961; on October 13, 1960, 6 "puts", 100 shares each, at $70 per share which expire January 16, 1961; and on October 17, 1960, one "put" on 100 shares at $69.00 a share which expires on January 6, 1961.

Also attached herewith is Exhibit "E", which shows the high, low, and closing prices and daily trading volume of Chock Full O'Nuts for the period October 4, 1960 through October 24, 1960, with appropriate notations as to the date the shares were sold short, the date the short sale was covered and the date the report was mailed. On October 25, 1960, Schwarzmann caused Capital Gains Research Bureau, Inc. to effect the sale of 1,000 shares of Frank Shattuck Company at prices ranging from $19½ to $20⅛. On October 11, 1960, Schwarzmann caused Capital Gains Research Bureau to purchase 6 calls of 100 shares each on Frank Shattuck Company at a call price of $14.30 each, which expire on January 13, 1961.

On October 28, 1960, Schwarzmann caused Capital Gains Research Bureau to purchase 1,000 shares of the Union Pacific at prices of $25½ to $25⅝. On October 31, 1960, Schwarzmann caused Capital Gains Research Bureau to purchase an additional 1,000 shares at prices

ranging from $25¾ to $25⅝. On November 1, 1960, Capital Gains Research Bureau distributed a market let- [fol. 19] ter recommending the purchase of Union Pacific Railroad stock.

On November 7, 1960, Schwarzmann caused Capital Gains Research Bureau to sell 2,000 shares of Union Pacific at $27.00 a share. The result of these transactions was a profit of $1,757.00. Attached herewith is Exhibit "F", which shows the high, low, and closing prices and daily trading volume of Union Pacific Railroad in the period October 28, 1960 through November 7, 1960. As part of this Exhibit, the dates of purchase and sale are also indicated and the date the report was mailed is also shown thereon.

As will be seen from the above, the pattern followed by Capital Gains Research Bureau has been to first effect purchase for its own account of a certain security, then to widely circulate among the thousands of its subscribers, as well as prospective subscribers and others, a report recommending the purchase of such security, which had the operative effect of causing a price rise in this stock with substantially increased volume, and then for Capital Research to sell in the rising market directly or indirectly generated by it the shares of stock it had purchased immediately before it mailed its report recommending purchase of the stock. As also shown above, it was also the pattern for Capital Research to take a short position in a security immediately prior to its distribution of a circular, recommending the disposition of said security, which operated to cause a decline in the price of this stock with increasing volume, and then for Capital Research to cover its short position in that declining market [fol. 20] by making purchases of said stock.

My examination of the bulletins, reports and other literature distributed through the mails by Capital Gains Research Bureau, recommending the purchase, retention or disposition of the securities hereinabove referred to, disclosed that it failed to reveal that immediately prior to the date of the mailing of this literature Capital Gains Research Bureau had purchased shares of the security which it had in such literature recommended that sub-

scribers and others buy, or had sold short the security which it had recommended that subscribers sell; and it failed to reveal in such literature that Capital Gains Research Bureau intended, shortly after the mailing of such literature, to sell the security recommended for purchase, or to buy the security recommended for sale.

During the aforesaid period, Capital Gains Research Bureau, Inc., purchased and sold the securities described in its various reports through the following broker-dealers, as presently known to me:

Bache & Co.
R. J. Buck & Co.
Dreyfus & Co.
Hardy & Co.
Henry Hentz & Co.
Laird Bissell & Meeds
Shields & Co.

No previous application has been made for the relief sought herein.

/s/ John R. Steinert
JOHN R. STEINERT

Sworn to before me
this 17th day of
November, 1960.

/s/ Raymond F. MacDonald
Notary Public
RAYMOND F. MACDONALD
Notary Public State of New York
No. 24-764 7650, Qualified in Kings
Co., Commission Exp. March 30, 1962.

[fol. 21] EXHIBIT "A" TO AFFIDAVIT

CONTINENTAL INSURANCE CO.

Date	High	Low	Close	Volume	Remarks
3/15/60	47 7/8	47 3/8	47 3/4	2500	Bought 500 shares
3/16/60	48 3/4	47 3/4	48 3/8	6400	
3/17/60	49	48	49	3200	
3/18/60	49 1/4	48 1/2	48 5/8	3100	Mailing date of Report
3/21/60	50	49	49 7/8	9000	
3/22/60	50 1/8	49 5/8	50	12200	
3/23/60	50 1/8	49 1/2	49 7/8	6000	
3/24/60	50 1/2	49 3/4	50 3/8	5900	
3/25/60	50 3/4	50	50	4700	
3/28/60	50 3/8	50	50 3/8	9800	
3/29/60	50 3/8	49 3/4	50	3700	Sold 500 shares

[fol. 22] EXHIBIT "B" TO AFFIDAVIT

UNITED FRUIT CO.

Date	High	Low	Close	Volume	Remarks
5/13/60	22	21 1/4	22	6500	Bought 2400 shares
5/16/60	22 3/8	21 5/8	21 3/4	6400	Bought 1500 "
5/17/60	21 3/4	21 1/4	21 1/2	5000	
5/18/60	21 3/4	21 1/8	21 1/8	5800	
5/19/60	22	21	22	8600	Bought 300 "
5/20/60	23	21 5/8	22 1/8	6600	Bought 1100 "
5/23/60	22 1/8	21 5/8	22	3300	
5/24/60	22 3/8	22	22	7200	
5/25/60	22 3/8	22	22	4600	
5/26/60	22 1/2	22	22 3/8	6400	
5/27/60	22 7/8	22 1/8	22 3/4	6100	Mailing date of Report
5/31/60	24 3/4	23 3/4	24 1/4	15200	
6/1/60	25 1/2	24 1/8	24 7/8	12700	
6/2/60	25 1/4	24 1/4	24 7/8	14700	
6/3/60	25 1/2	24 3/4	25 1/8	10000	
6/6/60	25 1/4	24 1/4	24 1/4	7300	Sold 2000 shares
6/7/60	24 1/8	23 5/8	23 5/8	6700	Sold 500 "
6/8/60	24 3/8	23 1/4	24 1/8	7600	
6/9/60	24 3/4	24	24	5800	Sold 500 "
6/10/60	24 1/2	23 5/8	24 1/2	6800	Sold 2300 "

[fol. 23] EXHIBIT "C" TO AFFIDAVIT

CREOLE PETROLEUM CORP.

Date	High	Low	Close	Volume	Remarks
7/5/60	28 7/8	28 1/2	28 5/8	2300	Bought 500 shares
7/6	28 5/8	27 7/8	28	4000	
7/7	27 7/8	26 1/2	27 5/8	2900	
7/8	28	26 3/4	27	2400	
7/11	27	25 1/2	25 1/2	5400	
7/12	26 3/8	25 1/4	26	4300	
7/13	26	25 1/2	26	5000	
7/14	26	25 1/4	25 1/2	6700	Bought 1500 shares
7/15	25 3/4	25 1/2	25 5/8	3300	Mailing date of Report
7/18	27	26	26 1/4	10300	
7/19	26 7/8	26 3/8	26 7/8	4500	
7/20	27 1/4	26 7/8	27	5700	Sold 1400 shares
7/21	29	27	28 1/8	5500	Sold 100 shares
7/22	29 3/8	28 1/2	29 3/8	4600	Sold 500 shares

[fol. 24] EXHIBIT "D" TO AFFIDAVIT

HART, SCHAFFNER & MARX

Date	High	Low	Close	Volume	Remarks
8/4/60	23	22 3/4	22 7/8	400	
8/5	22 3/4	22 3/4	22 3/4	400	
8/8	23	23	23	600	Bot 600 shares
8/9	23	23	23	100	
8/10	23 1/4	23 1/4	23 1/4	100	
8/11	23 1/2	23	23 1/2	500	
8/12	23 1/4	22 3/4	23	1800	Mailing Date of Rpt.
8/15	25 5/8	24 1/2	25 1/4	2800	
8/16	25 1/2	25	25 1/2	1600	
8/17	25 5/8	25 1/4	25 1/4	1200	
8/18	25 1/4	25	25 1/8	500	Sold 300 shares
8/19	24 7/8	24 1/2	24 3/4	1200	
8/22	24 7/8	24 3/4	24 3/4	800	Sold 300 shares
8/23	25 3/8	24 3/4	25 3/8	600	
8/24	25 1/2	25	25 1/2	600	
8/25	25 3/4	25 1/8	25 1/8	600	
8/26	25 5/8	25 3/8	25 3/8	300	

[fol. 25] EXHIBIT "E" TO AFFIDAVIT

CHOCK FULL O'NUTS CORP.

Date	High	Low	Close	Volume	Remarks
10/4/60	69	68	68	2400	Sold short 500 shares Bot 5 Puts
10/5/60	69 1/2	67 1/2	69 1/2	1700	
10/6/60	70 1/4	69 1/2	69 1/2	2000	
10/7/60	70	69 5/8	70	700	
10/10/60	70 3/8	69 1/2	69 5/8	400	
10/11/60	70 1/4	70	70 1/8	800	
10/12/60	73 1/2	70 1/4	72	1900	
10/13/60	72	71 1/4	71 1/2	1500	Bought 6 Puts
10/14/60	72 1/2	71 3/4	72	1100	Mailing Date of Rpt.
10/17/60	72 1/2	70 1/2	70 1/2	2500	Bought 1 Put
10/18/60	71	69 3/8	70	1000	
10/19/60	70	69	69 3/4	900	
10/20/60	69 7/8	67 1/4	67 1/4	1600	
10/21/60	67 1/4	65 1/8	66 1/4	8400	
10/24/60	65	60 7/8	61 3/8	7600	Bought 500 shares

[fol. 26] EXHIBIT "F" TO AFFADAVIT

UNION PACIFIC R. R.

Date	High	Low	Close	Volume	Remarks
10/28/60	25 3/4	25 1/4	25 1/4	7500	Bought 1000 shares
10/31/60	25 5/8	25 1/8	25 1/8	5800	Bought 1000 shares
11/1/60	25 1/2	25 1/4	25 1/2	5200	Mailing date of Report
11/2/60	25 7/8	26 5/8	26 5/8	15100	
11/3/60	27 1/2	26 5/8	27 1/2	17600	
11/4/60	27 3/8	27	27 1/8	19900	
11/7/60	27 1/4	26 7/8	27 1/8	11900	Sold 2000

[fol. 38]

#724

IN UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

60 Civ. 4526

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

-against-

CAPITAL GAINS RESEARCH BUREAU, INC.
HARRY P. SCHWARZMANN, DEFENDANTS

APPEARANCES:

Paul Windels, Jr., Esq.
Regional Administrator

Arthur Goldman, Esq.
Chief Enforcement Attorney

Henry R. Bright, Esq.
Attorney

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Leo C. Fennelly, Esq.
Of Counsel.

[fol. 39] OPINION—March 1, 1961

DIMOCK, D.J.

Plaintiff seeks a preliminary injunction against the carrying on of business practices which it alleges contravene the provisions of section 206, subdivisions (1) and (2), of the Investment Advisers Act of 1940, 15 U.S.C.

§ 80b-6(1) and (2). The entire section 206 as amended in 1960, reads as follows:

"§ *80b-6. Prohibited transactions by investment advisers*

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly —

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

[fol. 40] Defendant Capital Gains Research Bureau, Inc. is an investment adviser which publishes its advice in widely circulated bulletins and defendant Harry P. Schwarzmann is its president and sole stockholder.

Plaintiff cites five instances where defendants took a long position in a stock where they then advised the purchase of the stock without making any disclosure of their

position or intention, where there was immediately increased activity in the stock with a rising market and where defendants within a few days sold their stock at a profit.

Plaintiff cites one instance where defendants took a short position in a stock, where they then advised their clients that it was overvalued without making any disclosure of their position or intention, where there was immediately increased activity in the stock with a falling market and where defendants within a few days bought in the stock at a profit.

There is no claim of a violation of subdivisions 3 or 4 of section 206.

Subdivisions 1 and 2 deal in general with fraud. Is the course of conduct charged one which "operates as a fraud or deceit upon any client or prospective client" within the terms of subdivision 2? I conclude that the words "fraud" and "deceit" are used in their technical sense. The fact that the later added subdivision 4 expressly covers the case of a course of business "which is fraudulent, deceptive or manipulative" strengthens me in my belief that subdivisions 2 and 1 are respectively [fol. 41] confined in their aim to engaging in a course of business which actually "operates as a fraud or deceit upon any client or prospective client" or to the employment of "any device, scheme or artifice" with the intent actually "to defraud any client or prospective client". To give these subdivisions further effect would require a breadth of interpretation impermissible in a statute for wilful violations of which criminal sanctions are provided. See 17 U.S.C. § 80 b-17.

Subdivision 2 deals with the case where the acts of the investment adviser operate as a fraud and section 1 deals with the case where he intends to defraud even though his acts do not operate as a fraud. There is no proof here that any client or prospective client lost a single dollar by reason of defendants' acts so as to bring defendants within subdivision 2 or that defendants intended that any client or prospective client should do so so as to bring them within subdivision 1.

Perhaps it could be shown that defendants' operations in liquidating their long positions and covering their short

position affected the market price of the stocks and thus reduced the value of their clients' positions in the stock. No attempt at any such proof has yet been made, however.

Absent such proof there is nothing to indicate that defendants intended anything but maximum profits for their clients and prospective clients. If they were engaged in the manipulative enterprise charged it would be but natural that they would pick the stocks that they thought would move naturally in the direction in which they sought to move them artificially.

I need not decide the question of fact, difficult upon the [fol. 42] record, whether defendants had the dominant intention of affecting the price of a stock so as to realize on their own position in it when they advised their clients to buy or sell without disclosing that defendants' intention was to sell or buy as the case might be. Unless this resulted or was intended to result in loss to clients or prospective clients, it would be no more than manipulation which does not come within the interdiction of subdivisions 1 and 2 of the statute.

Motion denied and stay vacated.

Dated: March 1, 1961

/s/ E. J. Dimock
United States District Judge

[fol. 45]

IN UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Civil Action No. 60 CIV 4526

[File Endorsement Omitted]

[Title Omitted]

AFFIDAVIT—filed March 2, 1961

STATE OF NEW YORK)
) ss.:
COUNTY OF NEW YORK)

HARRY P. SCHWARZMANN, being duly sworn, deposes and says that I am the owner of Capital Gains Research Bureau, Inc. and a defendant herein.

I have not employed any device, scheme, or artifice to defraud nor have I engaged in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Neither have I ever, in my seven years as an investment adviser, written a single report on a questionable stock. Each and every recommendation of mine was carefully selected, thoroughly researched, and investigated, and represented an unbiased selection made in good faith with one purpose—and only one purpose—to provide what I considered a sound opportunity for long-term capital appreciation for my subscribers. I did not make these recommendations for the purpose of personal profit. Profits (or losses) in such security transactions as I may have had were insignificant incidents in the conduct of our business, as I will demonstrate.

This suit was unnecessary and inequitable because there [fol. 46] is no present law or regulation that prohibits an investment adviser from trading in stocks like anyone else, nor is there any present law or regulation which requires an investment adviser to disclose his position to his subscribers. If the SEC decided that investment advisers

should tell subscribers of all transactions in a stock, the SEC should have promulgated such a rule and thereafter seek to enforce it. They should not charge someone with a fraud where no such regulation exists. I have no objection to complying with such a rule, and the SEC was so advised prior to the commencement of this action.

The specific charge against us is that we indulged in fraud and deceit by failing to disclose our transactions in the recommended stocks. I told representatives of the SEC, prior to the bringing of this suit, that I did not for one moment believe that we were violating any of its laws or regulations. In proof of this, I pointed to the fact that all of the complained about transactions were conducted right out in the open, in our own name, without any attempt to conceal our identity. Had we deliberately and knowingly been attempting any fraud and deceit, the transactions of which the SEC complains could have been accomplished secretly.

THE BACKGROUND OF THIS INVESTIGATION

On Monday, November 14, 1960, I was out of town on business and was informed by my Treasurer via a long-distance call that the SEC had requested that he immediately produce copies of all of our recent releases to subscribers together with a list of the names of the brokers we had dealings with. I instructed him to cooperate fully. I then called the Regional Director of the SEC who said [fol. 47] he wanted to see me, and I arranged to cancel out various appointments so that I could be at his office at 10:00 a.m. on Wednesday. I flew into New York City Tuesday night and stayed there, and thus had no opportunity to go to my headquarters in Larchmont to gather any of my material or records so that I would be in a position to explain any transaction and accurately answer questions. The SEC had all of my brokerage statements before them, together with copies of all of our various bulletins. I, on the other hand, did not have as much as a single record with me, and consequently had to rely completely on my memory to answer their questions. Even then I felt quite secure in testifying, because I had a clear conscience, and nothing to hide from anyone.

Although this meeting had been described to me as a "preliminary hearing", it lasted something a little over two hours, and I fully expected that it would be followed by other meetings and hearings. However, hardly 24 hours after its termination, and without a word of warning, the SEC precipitously brought suit, which was wholly unnecessary, charging me with fraud and deceit. In other words, after a two-day investigation of my records and a meeting that lasted about two hours, I suddenly found myself stripped of the most important thing I had in the world—a good name and reputation for honesty and fair dealing that had never previously been questioned. To become an investment adviser seven years ago, I voluntarily gave up the presidency of a very fine corporation that had paid me an average income of $72,500 a year for the seven years prior to my registration as an adviser. Imagine, then, how I feel at 55 years of age, with over 40 years of solid business experience behind me from the time I got my first job as an office boy with the [fol. 48] U.S. Rubber Co. on my fourteenth birthday, to find myself being labeled a fraud and cheat without ever having had a decent chance to defend myself.

The Court can understand that, in a business such as mine, where a man's good name is decidedly more important than the size of his bank account, the mere bringing of a suit by the SEC, charging fraud and deceit, regardless of its merits or necessity, injures my business reputation and me personally. The injury to me is irreparable.

the SEC, without issuing any regulation and asking if I would abide by it, and knowing that I was and still am unaware of any violation of law, and that no fraud was perpetrated by me, precipitously brought this action, knowing full well that the mere publicity of it would tend to destroy my business, and completely undermine the confidence so very many people in all parts of the country had in me prior to this suit.

Not content with publicizing the information contained in the moving papers, in violation of law (I am informed), they disclosed to the press information not contained in the moving papers but acquired in a hearing. I am in-

formed and believe that Section 80 b-10 (b), Title 15, U.S.C., provides the Commission "shall not make public the fact of any investigation * * * nor * * * the results * * * or any facts ascertained during such investigation".

Despite these clearly defined restrictions on publicity designed and spelled out to protect innocent people and prevent the destroying of a reputation, and prejudicing before a fair hearing, such statements as the following appeared in the public press:

[fol. 49] In the "Daily Times", November 18, 1960, on the front page (a local paper in my town of Larchmont):

> "According to Henry B. Bright of New York, senior attorney for the SEC, who brought the complaint against Schwarzmann, 'this is the biggest fraud of its kind which we have discovered on the market in the last 10 years.'"

In the "New York Herald Tribune" on November 18, 1960:

> "Government lawyers estimated that the trading activities in seven stocks over the last six months netted Mr. Schwarzmann around $20,000.
>
> "His gross revenue from the advisory services come to an estimated $570,000 a year. One informed guess put the Schwarzmann net income before taxes at $100,000, and after taxes at some $40,000 from his advisory services.
>
> "Attorneys described Mr. Schwarzmann as a person 'who looks like a successful businessman' and said he acted as his own security analyst while running a staff of twelve employees at the Larchmont office. He owns his printing shop and turns out the neat offset bulletins on either yellow or white paper."

I am informed and believe that not only have the SEC representatives violated this statute on publicity but that its attorneys have violated Canon 20 of the Canons of Professional Ethics in giving newspaper reporters information outside of the record of the papers which appear in Court, which may prejudice the administration of justice.

THE ALLEGED NON-DISCLOSURE

It is claimed that Capital Gains should have disclosed its trades in any stock which was the subject of a report.

The only requirement of disclosure, I am informed, by an investment adviser is when he deals as a principal directly with a customer in the purchase or sale of stock (Title 15, USC, Section 80 b-6 (3)).

To my knowledge there are no rules or regulations of the SEC otherwise providing for any such disclosure. [fol. 50] However, I have no objection to so disclosing and the SEC was so told before this suit and that hereafter such disclosure would be made if that was the SEC position.

I am advised and believe that thousands of broker-dealers under the Securities Exchange Act of 1934, and rules and regulations of the SEC, may sell as a principal their own stock, which they recommend to the customer, with the following statement which is considered adequate disclosure by the SEC:

> "The firm of .... and/or its partners may from time to time hold a position in the securities mentioned herein.".

NATURE OF THE BUSINESS

Capital Gains Research Bureau, Inc. has been registered, since about July, 1959, as an investment adviser pursuant to the Investment Advisers Act of 1940. Prior to that time, and since 1953, I was a registered investment adviser doing business as an individual under the trade name of "Capital Gains Research Bureau". I commenced and built up this business myself. The Bureau has two publications. One, issued periodically, is distributed to subscribers thereto at a fee of $24 per year, known as "Facts on the Funds", which gives statistical information of the changes effected in the portfolios of large mutual funds. It also issues monthly to subscribers, for $18 per annum, "A Capital Gains Report", which analyzes statistical and other data as to a specific stock and generally with a recommendation as to purchase.

Contrary to the implication in the moving papers, the reports on specific stocks are not issued to non-subscribers at or about the time the report is issued to subscribers. [fol. 51] Occasionally the report is issued to non-subscribers as a means of advertising to obtain new subscribers, but this is only done after the subscribers themselves have had ample opportunity to buy stock if they wish to do so.

There are about 20,000 subscribers to "Facts on the Funds" and about 5,000 subscribers to "A Capital Gains Report". The object of the business, insofar as it concerns the latter, is to research a stock, and, on the basis of statistical data, management consultations, etc., to present this to subscribers in the belief that, where purchase is recommended, they may make a long-term capital gain.

It is obvious that the success of this business depends on whether the information and recommendations provided to the subscribers are sound and correct so that they profit thereby. It is also obvious that if it were otherwise the business could not survive.

Copies of "A Capital Gains Report", as to stocks referred to in the moving papers, are attached. A reading of these reports themselves will disclose they were made in good faith for the purpose of providing the subscriber with information as to a stock in which he might invest with profit.

As I will demonstrate hereafter, the fact that, in the instances alleged in the moving papers, I made certain trades in no way influenced nor was the cause of my issuing any bulletin or recommendation on any stock. My transactions were in no way in conflict with the interests of my subscribers. In fact, as to five of the six stocks referred to as having been recommended for purchase, the subscriber, if he had purchased at the price at the time of recommendation, would have had a profit—in one in- [fol. 52] stance over 50% within two months. The subscriber would also have been able to sell at prices higher than my sales. My subscribers definitely were not defrauded or deceived by lack of knowledge of the trades which I made, as I shall demonstrate as to each security involved.

FRANK G. SHATTUCK COMPANY

At the time of the release of our October 14, 1960 bulletin—which was a study of relative values of Chock Full o' Nuts and Frank G. Shattuck—we held "call options on 600 shares of Shattuck which had been bought at a total cost of $1,518.44. We had recommended Shattuck at various times in the past several years, starting at a price of $8-$9 (as against the price mentioned in the bulletin of $16, and a current price of over $27). Eleven days after our bulletin was out, we exercised our "call" options and realized a profit of $695.17.

In the SEC charges against us, they make the statement that we sold 1,000 shares of Shattuck, but they withheld from the Court *when* we bought these 1,000 shares. Their charge is so worded as to give the impression that in addition to the 600 shares on which we owned "call" options, we also had another 1,000 shares when the report was released. This is absolutely untrue because the 1,000 shares referred to were bought on October 20th (six days after the report had been released) and was sold on October 26th for a profit of $615.22.

CHOCK FULL O' NUTS

When our bulletin of October 14, 1960, on Chock Full [fol. 53] o' Nuts and Shattuck was issued, we were short 500 shares of Chock Full o' Nuts and also had 12 "put" options on the same stock which had been acquired at a cost of $6,962.50. The SEC charges that we advised our clients to sell Chock Full o' Nuts and to buy Shattuck. It is absolutely untrue that we recommended the sale of Chock Full o' Nuts—we did recommend the purchase of Shattuck. Never having previously recommended Chock Full o' Nuts for purchase by our subscribers, we had no knowledge of whether even a single subscriber owned this stock when that bulletin was released. Actually, it was the only stock that we wrote about which we sold short and our selling short was in the conviction that the stock was overpriced. As a matter of fact, back in July and again in September, 1960, long before we even thought about writing the bulletin of October 14th, we had closed out two separate short sale transactions in this stock.

While it is true that we covered our short position of 500 shares of Chock Full ten days after our bulletin with a profit of $2,772.33, it is also true that the 12 "put" options on the same stock, acquired at a cost of $6,962.50, are completely worthless as of now, so that we had a net loss on the transactions of over $4,000. Our trading in this stock had nothing to do with our subscribers, but from a conviction that the stock is too high. In connection with the Chock Full transaction, the SEC charges that:

> "It is also the pattern for Capital Gains Research Bureau to take a short position in a security immediately prior to its distribution of a circular recommending the disposal of such security which operated to cause a decline in the price of this stock with increasing volume and then have Capital Gains Research Bureau to cover its short position in that declining market by making purchases of said stock."

[fol. 54] This is a downright misleading statement because Chock Full o' Nuts is the only stock that I wrote about this year that I sold short, and I fail to see where there could possibly be developed a "pattern" of short selling when only one stock was sold short in a whole year's time.

CONTINENTAL INSURANCE COMPANY

This is one of the blue chip stocks selling on the New York Stock Exchange, as can be seen from the report issued by us March 18, 1960. In the moving papers there is an Exhibit A purporting to give to the Court our trading in this stock. The SEC, however, failed to disclose to the Court the fact that four days *after* the issuance of the report of March 18, 1960, we purchased an additional 500 shares which we sold 13 days after the report for a loss of $595.21 so that our net profit on total transactions in 1,000 shares was $89.61. The recommendation to purchase this stock for gradual appreciation was made in good faith and in the belief, which I still hold, that anyone who buys it for long-term gain will be rewarded. The SEC does not complain about, and, indeed, ignores, our purchase of the 500 shares after the report, but contends

that buying 500 shares three days before issuing the report and selling the stock 11 days after the report was a fraud and a deceit on subscribers. There is no conflict between our purchase of the shares prior to the report and selling it 11 days after the report as any subscriber had complete opportunity in the interim to purchase. The fact is that the stock, when recommended, was selling at 48⅝ and closed on December 9th at 52⅜, in spite of a generally declining market that has existed since the date this recommendation was made.

[fol. 55] Continental Insurance, which has 12,000,000 shares outstanding, has been recommended by the following New York Stock Exchange houses subsequent to our recommendation: H. Hentz Co., March 22, 1960, at 50; Francis I. duPont & Co., April 6, 1960; David J. Green & Co., June 2, 1960.

UNION PACIFIC RAILROAD

On November 1, 1960 for the fourth time in a year, we called attention to this leading railroad and suggested that, at the depressed price of $25, it should be bought. Prior to that date, on October 20, 1960, Standard & Poor's publication "Transportation Securities" had carried a special story on this stock which confirmed our opinion that it was very much underpriced. On October 28th and again on October 31st, I made purchases of Union Pacific totalling 2,000 shares at prices ranging between 25⅜ and 25⅝, which were just fractionally above the year's low. My decision to write my November 1st story about Union Pacific was triggered by two special developments. One was a full-page ad in the October 31st issue of "Time Magazine" by the Association of American Railroads which showed the comparative costs of moving a ton of freight by truck, by airplane, and by efficient low-cost railroads. At just about the time of this ad, Union Pacific released its figures for the first nine months of the year which showed a drop in profits of less than 5% despite a drop in the price of the stock of 34% from last year's high of 38⅜. With over 22,000,000 shares of stock outstanding, my purchases of 2,000 shares had absolutely no effect on the market as can be seen from the

fact that they were consummated within a price range of ¼ of a point.

[fol. 56] When I was questioned at the preliminary hearing regarding my sale of Union Pacific on November 7th, which was six days after the release of my report, I told the SEC that the sale was made on Election Eve because I also owned at the same time 2,000 shares of Illinois Central and had decided to cut my position for the election. That I chose to sell Union Pacific instead of Illinois Central was due entirely to one consideration and it was this: Had I sold the Illinois Central, I would have sustained a loss, whereas by selling the Union Pacific I virtually cut my railroad holdings in half and realized a profit of $1,599.76.

CREOLE PETROLEUM

This company is a subsidiary of Standard Oil of New Jersey. In the bulletin of July 15, 1960, giving information about this huge company, we did not come out and recommend the purchase of the stock, but after stating pros and cons we said: "Even so, Creole could be an interesting stock for clients to look into with the help of their own brokers." On that day the stock was selling close to its low for the year of around $25 as against the year's high of $46. In August and again in November, 1960, Creole sold above $32 so that if any subscriber had purchased the stock as a result of our bulletin, he had ample opportunity in which to realize a profit, and a greater profit than we, assuming that any of them had bought it as a result of our bulletin. Our profit on the 2,000 shares of Creole amounted to $569.15.

UNITED FRUIT COMPANY

This is the only stock of those listed which would not have been profitable if subscribers bought.

[fol. 57] The company had paid dividends since 1899 and it is the largest banana enterprise, in addition to which it is engaged in shipping sugar and tropical crops and in oil exploration.

It was recommended by one of the finest, largest, and most respected investment services, United Business Serv-

ice, in its annual forecast for 1960, as being one of the ten stocks to buy for appreciation in 1960. It was recommended at a price of $27.

The same service, on December 5, 1960, recommended its subscribers to hold the stock despite the adversity with which it has met in the market.

HART, SCHAFFNER & MARX

The SEC refers to a transaction involving 600 shares of Hart, Schaffner & Marx which produced a profit of $837.97 after being sold six days following the issuance of the August 12, 1960 bulletin. What the SEC failed to point out is that back in February and March of this year, which was five to six months before our bulletin, we had bought and sold 700 shares of this same stock, a transaction which resulted in a profit of $2,243.90. Reference to our bulletin of August 12th will show that we cautioned our clients not to be in a hurry to accumulate shares in this company with the following comment: "New purchases are recommended around the $23-$24 level, but clients are reminded that with only 875,695 shares outstanding it may take a little time to accumulate stock without needlessly disturbing the market." If we were trying to excite the market in this stock so that we could sell our small holdings of 600 shares with an unusual profit, we certainly chose the wrong language for this purpose.

[fol. 58] In conclusion, there was no fraud or deceit in the transactions. Every recommendation to subscribers was in good faith and in all but one subscribers had opportunity for a profit. Capital Gains had a right to trade and there was no conflict of interest in its trades with the interests of subscribers. There has been no violation of any law or rule.

Had the SEC wished to promulgate a rule on disclosure, I am, and would have been at all times, ready to comply. The SEC, however, should advise of such a rule and ask compliance before precipitously rushing in with an unwarranted action accusing me of fraud and deceit and destroying my business and reputation by insinuation.

There is not sufficient money in the world to pay me for the physical and mental torment I have suffered in the past few weeks, to say nothing of the humiliation and heartache that my wife and children have had to suffer in the most trying period in their entire lives due to this unjustified bureaucratic action.

/s/ Harry P. Schwarzmann

Sworn to before me this
13th day of December, 1960

/s/ Dorothy Howland
DOROTHY HOWLAND
Notary Public, State of New York
No. 41-6986600
Qualified in Queens County
Cert. Filed in N. Y. County
Commission Expires March 30, 1962

[fol. 59] **Attachment to Affidavit**

A Capital Gains Report

CAPITAL GAINS RESEARCH BUREAU, Inc.

SPECIAL RECOMMENDATION

March 18, 1960

CONTINENTAL INSURANCE COMPANY
(Listed N.Y. Stock Exchange .. Symbol CIS .. Current price about $48)

As an insurance underwriter, Continental ranks as the largest exclusive fire and casualty company in America, with assets of over $1,500,000,000, and premium income in its latest year of over $800,000,000. As an investment portfolio manager, Continental's year-end holdings of stocks and bonds worth $1,343,351,529 made it almost as big as the largest Mutual Fund in America ... the giant Massachusetts Investors Trust - whose assets on 12/31/59 were $1,557,700,000.

To round out this quick description of the Company, it might also be added that Continental is the only major insurance company listed on the N.Y. Stock Exchange, where it enjoys the enviable reputation of being one of the four oldest consecutive dividend payers of all listed companies - with a record of having paid cash dividends every year without interruption since 1853. It has 12,000 salaried employees, and its 11,998,290 shares of stock are held by more than 34,000 shareowners.

Unlike the shares of so many other blue-chips, Continental Insurance - as of now - is not a popular item with America's big Mutual Funds and Closed-End Investment Companies. But that, in our judgment, is a strong plus factor for the stock at current depressed prices, because when only 7 of America's 72 Funds with individual assets of over $50,000,000 hold a stock, you have only a handful of potential sellers ... but dozens of potential buyers! (To better appreciate the true significance of this point, look back on the situation in A.T.& T. in the summer of 1956 - months before the famous split - when your attention was first called to the sudden appearance of large buying of this stock by many Funds which previously didn't own a share. A.T.& T. was definitely an unpopular stock with the Funds in those days, but when some of the big ones began to buy, they didn't have to wait very long before they had plenty of company.)

Here's a quick picture of the 7 Funds who held Continental according to their last reports: Insurance Securities 387,643 shares; Century Shares 105,000; Investors Stock Fund 45,200; One William Street 40,000; Consolidated Investment Trust 17,082; Commonwealth Investment 5,850 and Massachusetts Life Fund 4,660 shares. Total of all 7 Funds - 605,435 shares, worth about $30,000,000.

At its present price of around $48, Continental is selling 27% below last year's high of over $66 .. which was made in March, a few months before the Company declared a 10% stock dividend (in addition to the regular 50¢ quarterly cash payment). This comparison with last year's market, however, is not nearly as important as the fact that today's price is about $35 (or 40%) below the estimated $83 equity value per share which existed on December 31, 1959! True, this $83 per share equity value has shrunk somewhat because of the decline in stock prices since the first of the year, but the shrinkage did not affect its entire $1.3 billion portfolio, because that portfolio included almost $450 million of bonds.

(over, please)

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As anyone who is even remotely familiar with the fire and casualty underwriting field well knows, the past few years were bad ones, so bad - indeed - that Continental operated the insurance end of its business at a very substantial loss. In 1957, for example, investment income of $38.6 million was smothered by an underwriting loss of $58.2 million. In 1958, investment income of $39.5 million was again snowed under by an underwriting loss of $53.9 million. But in 1959 the picture brightened considerably when investment income of $41.4 million exceeded the underwriting loss of $31.5 million by a margin of $9,851,270.

To understand the reason for the Company's large underwriting losses in the past few years, it is first necessary to know something about the fire and casualty insurance business. Briefly, this business is a cyclical one with several years of unprofitable operations usually being followed by similar or even longer periods of profitable operations. Behind this cycle of so-called "lean and fat years" lies a time lag in adjusting premium rates to actual underwriting experience. To cite just one example: Last August a substantial increase in automobile rates was authorized in New York State but this was the first increase in two years even though everyone knew that the underwriters were taking a terrific beating on this type of insurance. Obviously, a rate increase such as this does not immediately become effective on outstanding policies, so the benefits thereof are deferred in many cases for as long as a whole year. In the case of other forms of insurance, such as fire, where three-year policies are by no means uncommon, it is easy to understand that rate increases granted last year may not even take effect until this year, next year, or even 1962.

In the present year, thanks to the "delayed action" of previous rate increases, Continental may very well break even on its insurance operations, and perhaps even show an actual profit. If this comes to pass, then last year's net profit of only 83¢ a share (which represented the difference between net investment income of $3.45 a share and an underwriting loss of $2.63 a share) could be turned into an actual net profit of somewhere between $3.50 and $4.00 a share. Looking beyond the present year, and taking into account steadily increasing investment income, the growth trend of the insurance business, and the Company's possible entry into the life insurance field, it is easy to see a further substantial increase in total profits in succeeding years. At this point it should be stressed that Continental is in a rather unique tax position at the present time. For one thing, it has a substantial tax loss carry-forward arising out of its unprofitable insurance underwriting experience in recent years. For another, the effective tax rate on its income from investments - when it does pay taxes - is extremely small because while it pays the full 52% tax on income from government bonds, it pays no taxes on its holdings of municipal securities, and receives an 85% tax credit on dividends from its huge common stock portfolio.

Space does not permit of a complete tabulation of the Company's enormous stock and bond portfolio, but here are a few highlights: Holdings of Bonds totalled $448,864,935; Preferred Stocks - $35,621,067; Common Stocks-$858,865,527. Here are some of its biggest stockholdings: A. T. & T. - 375,900 shares; I. B. M.-146,384 shares; G. E. -274,800 shares; duPont-123,300 shares; Eastman Kodak-137,900 shares; G. M.-349,500 shares; Corning Glass-76,250 shares; Nat'l. Steel-147,500 shares; Gulf Oil-536,782 shares; Shell Oil-154,670 shares; Union Carbide-172,000 shares; Std. Oil N. J.-777,445 shares; U. S. Gypsum-135,000 shares; Texaco-294,576 shares; Amerada-147,100 shares; First Nat'l. City Bank of N. Y.-229,450 shares; Morgan Guaranty Trust Co.-117,900 shares; Hanover Bank, N. Y.-256,500 shares.

Continental Insurance - in effect - is a giant Investment Trust whose shares can be bought at a considerable discount from equity value, with an enormous insurance business - now poised for a return to profitable operation - thrown in for good measure! We recommend purchase for gradual but substantial appreciation.

H. P. Schwarzmann

[fol. 61]

A Capital Gains Report

CAPITAL GAINS RESEARCH BUREAU, Inc.

SPECIAL RECOMMENDATION

May 27, 1960

UNITED FRUIT COMPANY

(All that's bad about United Fruit, in our opinion, is known ... and fully reflected in its current price, which is a sadly depressed 5 times average yearly earnings for the 10-year period 1949/58, inclusive. What isn't so generally known, we believe, is what caused the setback, and what the new management is doing to prevent a recurrence, and to restore a large measure of its former great earning power.)

Just nine short years ago, with its stock selling at $73, United Fruit reported to its 62,000 happy stockholders that the year 1950 had indeed been a good one, with sales of $313,273,276 having produced a net profit after taxes of $66,727,939 ... equal to $7.60 a share! The cash dividend that year was a handsome $4.75 a share. Early this year, United's brand new President, 55 year-old Thomas E. Sunderland (formerly Vice President, General Counsel, and Director of Standard Oil Co. of Indiana) - had the tough job of telling his much enlarged army of 91,000 unhappy stockholders that the year 1959 had indeed been a bad one, with sales of $312,912,474 having produced a net profit of only $12,067,670 ... equal to $1.39 a share! The 1959 dividend was a not-too-handsome $1 a share.

Coming on top of last summer's first dividend interruption in 60 years (since resumed), the 1959 report seemed like the last straw. But a disturbed and disillusioned stockholder never knows whether he is being hit with a straw or a baseball bat, so when wide publicity was given to Castro's plan to expropriate virtually all of the Company's Cuban sugar producing lands, the stock took still another tumble to establish a new low of $21 ... less than half last year's high of $45, and $52 a share under its 1951 peak. Unfortunately, most stockholders don't bother much with balance sheets, or those who dumped their holdings on the Cuban news would have taken the land seizure for what it was really worth ... a matter of maybe $4 or $5 a share on a stock that had a net asset value of over $40, or almost twice the market price. (And even that loss has definite tax benefits for future use.) Profit-wise, the sugar loss was no catastrophe either, because only about 5% of the Company's earnings are estimated to have come from this source in recent years.

Recognized as the world's largest grower and marketer of bananas, in which role it accounts for an estimated 60% to 65% of all bananas consumed in the U.S. and Canada, and over 15% of those consumed in Europe, one would assume from Wall Street's bearishness on the stock that bananas were going out of style. But if that was the case, United's unit sales would have suffered drastic shrinkage in the last ten years. Instead, 1959 sales amounted to 41,609,668 stems, equal to 1,402,085 tons; whereas in 1950 it sold 35,495,682 stems, equal to 1,371,750 tons.

No, the banana isn't going out of style, and today represents a per-capita consumption in this country of an estimated 19 pounds a year, or more than 1% of the approximate 1,600 pounds of all foodstuffs consumed by each of us in a year's time. Teen-agers find that it fills, at least temporarily, their bottomless pits which are called stomachs in other age groups. Weight watchers, who are

(over, please) 61

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limited in their daily caloric intake, discover that one medium banana accounts for only 88 calories, but eases hunger as it provides vitamins and minerals. In hospitals, nutritionists select the banana for sick-room trays of patients requiring low sodium, low cholesterol diets, or bland or semisoft diet menus. The first solid food given to most new-born babies, and yet one of the most nourishing, most easily digested, and most adaptable foods for people of all ages, the banana - far from going out of style - quite obviously is here to stay!

What, then, has been the trouble with United, and why did the Board of Directors have to reach out into a totally unrelated field to find a new President? Clearly, the trouble is not financial ... although it must be admitted that the Company was liberal to a fault in catering to its stockholders in its most prosperous years. This excessive generosity is vividly pointed up in two simple comparisons: In the 10 years 1949/1958, inclusive, United earned an average of $4.60 a share, and paid out in cash dividends an average of $3.55 a share per year, for a pay-out of 77%! In those same ten years, in which it earned a total of over $46 a share, the book value of the stock increased only 26-1/2%, from $32.12 a share to $40.64. Even then, however, the Company's latest balance sheet is still a strong one, with no bank debt, no bonds, and no preferred stock ahead of the 8,717,425 shares of Common Stock representing a total stockholder equity of $354,234,609.

Disease and windstorm are the banana plant's two worst enemies, and losses from both directions in the past few years were unusually severe. But management is not sitting on its hands waiting for nature to ease up on the furious destruction of the recent past. Instead, it is moving just as rapidly as humanly possible to get both of these hazards under scientific control ... and here are some of the measures being taken toward that end as outlined by President Sunderland:

> "The number of stems of bananas sold in 1959 was approximately 11% greater than in 1958, but due to a reduction in weight per stem, the total weight sold was approximately the same. This reduction in weight per stem was caused by unexpected results of a new spray used to control Sigatoka (leaf spot). Because most of the costs per stem of production and handling remain constant regardless of weight, the decreased weight per stem sharply increased costs per pound.
>
> "In 1957 preliminary studies and reports of several years' satisfactory experimentation in other banana growing areas indicated that Sigatoka could be controlled by the use of orchard oil sprays applied by plane and by helicopter on a more economical basis than by the Bordeaux spray method formerly used. Adopting these new sprays resulted in reduced labor and material costs and eliminated the need for large capital outlays for pumping and mixing stations plus elaborate pipe systems for all new areas. However, in 1959 it became evident that while Sigatoka was being controlled, the plant itself was being adversely affected in many of our divisions, with reduced weights per stem, fewer stems per acre and generally lower quality fruit. In September 1959 the return to Bordeaux mixture and other copper-based fungicides was started. Simultaneously, a concentrated effort is being undertaken to retain the economies of aerial application. With these changes, considerable improvements are expected both in the weight per stem and in quality of fruit during 1960."

Turning then to the matter of windstorm damage, which has been destroying millions of stems of bananas a year, President Sunderland had this to say:

> "Over the last few years, a Gros Michel banana plant has been developed which is sturdier and shorter than the one formerly grown. Propagating material is now available with plantings being expanded as rapidly and as economically as possible. Because of its shorter height, this plant is much less affected by windstorm."

On the last page of this report appears a pen-and-ink sketch which shows the difference between the new and more wind-resistant, low-growing Gros Michel plant now being planted, and the taller

(continued)

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Gros Michel which has come in for so much destruction in recent years. Note the aerial photo of just what happened to both types after a severe windstorm. The taller Gros Michel plants were totally destroyed, whereas the low-growing type escaped practically unharmed.

Introduced into the United States a little over 80 years ago as a curiosity, bananas today are "big business" with well over three billion pounds a year being consumed right here. However, unlike most other popular foodstuffs, bananas cannot be grown in the United States and can only be grown successfully in humid, tropical areas where temperatures range between 55° and 105°F. But bananas have two little-known virtues that are important to a solidly entrenched giant like United Fruit, with its more than one-half million acres of land, its 1,400 miles of railways, and its fleet of 55 refrigerated steamships. Virtue #1: Bananas are not a seasonal crop, but are grown on a year-round basis. Virtue #2: Their cycle of development from planting to harvesting is only about 12 to 15 months, which means of course that the Company will not have to wait an eternity to begin to derive the benefits of its new low-growing Gros Michel plants.

After our discussions with top management in Boston, we came away feeling that the Company's sharply stepped-up research efforts must inevitably produce a solution to a sizeable portion of its windstorm and disease problems. While this cannot possibly happen this year, the Company is clearly on the right track, and should soon have its entire banana operation on a decidedly more profitable basis than was the case in the last couple of years.

Apart from this, we have other reasons for being optimistic about the future of United Fruit. For one thing, we know that the new management plans to use some of its huge resources to diversify, and in this connection recently hired the well-known research and consulting firm of Arthur D. Little, Inc., to study new activities the Company might undertake. President Sunderland himself made the statement, and we quote:

> "A broader base for our operations and a diversification into other activities will be a healthy development. For some time we have had small programs in cacao, palm oil, cattle, petroleum, and tropical hardwoods. We plan a careful profit appraisal of each of them and a vigorous development where justified to improve their volume and profit margins. The Company is also evaluating the use of its properties in the tropics for producing either food crops or products for industrial uses such as chemicals, packaging materials, cattle feed, vegetable oils, and fertilizers."

For another, the Company's new policy of selling, leasing, or contracting to nationals as much of its banana-producing land as can be reasonably accomplished... should go far toward easing political tensions and disturbances in the Latin American countries in which it operates. This new policy, said TIME Magazine in its May 16th issue, "is partly designed to appease what President Sunderland called the understandable desire of Latin Americans to own their own land and grow their own crops for sale in the international markets. But it has another, even more compelling purpose: to raise United Fruit's profits."

At this point it should be mentioned that as a condition of his employment, United Fruit's new President was given stock options for a total of 50,000 shares as follows: On November 2, 1959, the first 20,000 was optioned to him at a price of $24. The balance of 30,000 shares will be optioned at 95% of the market price on each of the following dates: November 1, 1960, November 1, 1961, and November 1, 1962.

For the sophisticated investor who can assume what we judge to be a relatively modest risk of loss at present sorely depressed prices, in return for a possible "windfall" Capital Gains profit of as much as 100% over the next two or three years, the shares of this $384 million Company are recommended for purchase at this time. Having sold at or above $45 in every year in the past fourteen, the stock also has excellent possibilities for those who are interested in short-term gains.

H. P. Schwarzmann

[fol. 64]

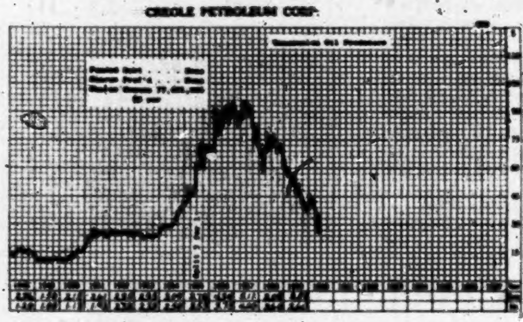
This aerial photograph was taken shortly after a severe blowdown and is a striking example of [illegible] damage to banana plants. The low-growing type of plant outlined here by white dots shows dramatically its wind resistance as compared to the surrounding taller Gros Michel plants which were totally destroyed.

CG NEWS AND VIEWS

CAPITAL GAINS RESEARCH BUREAU, Inc.
LARCHMONT, NEW YORK
TELEPHONE TEnnyson 4-7150

AT $26, CREOLE PETROLEUM (95% OWNED BY STANDARD OIL OF NEW JERSEY) IS DOWN 72% FROM ITS '57 HIGH OF $96!

CREOLE PETROLEUM CORP.



One of Standard Oil Company of New Jersey's principal sources of revenue is the dividend income it receives on its huge holdings of Creole Petroleum stock (listed on the American Stock Exchange). Currently trading around $26, against this year's high of $46, and a 1957 high of $96, Jersey owns about 74,000,000 shares of Creole, or 95% of the total issue of 77,621,210 shares.

At the 1957 peak of $96, Jersey's holdings of Creole had an indicated "paper" value of over $7 Billion. Today those holdings have a "paper" value of about $2 Billion.

Based on Creole's present dividend of $2.60 a share, Standard of New Jersey has an income of about $192,000,000 from this investment, but as recently as 1957 - when Creole paid $4 - this income totalled almost $300,000,000.

If one could be sure that Creole would continue to pay its present $2.60 a share dividend, the stock would be a fine income producer . . . with a yield of 10%. And, after having been on the toboggan for three whole years, it might even have some dynamic Capital Gains possibilities, especially with 95% of the issue "wrapped up" in Jersey's strong box. But there's obviously a big question about this, or the stock wouldn't be selling where it is. Even so, Creole could be an interesting stock for clients to look into with the help of their own brokers.

According to our records, only one of America's 74 largest Funds owns Creole, and that one is National Securities Stock Series. This Fund, however, has been a buyer of stock in recent months . . . increasing its 40,000 shares to 100,000 shares in the six months ended October 31, after which it bought another 23,000 shares in the six months ended April 30, to raise its holdings to 123,000 shares.

July 15, 1960 H. P. Schwarzmann

Chart used thru courtesy of M. C. Horsey & Co., Publishers

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CGRB

CAPITAL GAINS RESEARCH BUREAU, Inc.

Registered with the Securities & Exchange Commission as Investment Advisers

special bulletin

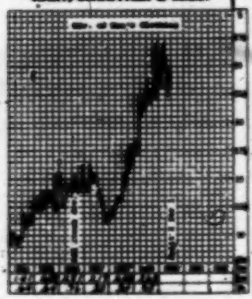
Larchmont, New York • Telephone Tennyson 4-7180

August 12, 1960

HART, SCHAFFNER & MARX

Listed New York Stock Exchange - Current Price about $23/$24

HART, SCHAFFNER & MARX



Selling for only 7-1/2 times last year's earnings of $3.24 a share, and for less than its net working capital of over $26, and at a discount of 40% from its net worth of $39 a share, this is one of the comparatively few companies to report increased earnings for the first six months of its new fiscal year ended May 31. True, the increase was modest - from $1.38 a share last year to $1.46 in this latest period - especially with sales up 10%, but this is accounted for by the fact that manufacturing profits in the first six months were relatively more attractive than those of the (higher profit) retail division - owing to the unfavorable spring weather in most sections of the country.

With earnings for the full year ending November 30 likely to run between $3.35 and $3.50 a share, this neglected stock has much to offer in today's market where so many issues are thought of as bargains "because they sell for only 20 times earnings".

Current dividend of $1.20, which yields 5.2% and is being earned better than 2-1/2 times over, leaves plenty of room for an increase or an extra. (The Company split its stock 2-for-1 in April of this year.)

SALES & PROFITS - PAST 6 YEARS

Year Ended Nov. 30th	Net Sales	Net After Taxes	Net Per Share
1959	$83,141,773	$2,810,796	$3.24
1958	76,148,541	1,526,864	2.09
1957	80,812,061	1,894,684	2.17
1956	79,331,828	2,457,831	2.81
1955	74,771,105	1,736,352	1.98
1954	66,575,717	1,228,566	1.41

New purchases are recommended around the $23/$24 level, but clients are reminded that with only 875,686 shares outstanding it may take a little time to accumulate stock without needlessly disturbing the market.

H. P. Schwarzmann

Chart used thru courtesy of M. C. Horsey & Co., Publishers

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CGRB special bulletin

CAPITAL GAINS RESEARCH BUREAU, Inc.
Registered with the Securities & Exchange Commission as Investment Advisers

October 14, 1960

A STUDY OF RELATIVE VALUES
CHOCK FULL O'NUTS . . . now selling at $70
FRANK G. SHATTUCK CO.(SCHRAFFT'S) . . . now selling at $16

Back in October '58, when Chock Full O'Nuts was first offered to the public at $15 a share, the Company's report for the fiscal year ended July 31, 1958 showed sales of $24,634,177, on which it realized a net profit of $1,313,076, equal to $1.56 a share. A few days ago the Company reported that in the fiscal year ended July 31, 1960 its sales amounted to $28,014,472, on which it realized a net profit of $1,815,557 -- equal to $2.14 a share.

In two years' time, then, sales moved up 14%, and profits 37%. But in those two years, some spectacular things happened to Chock Full O'Nuts Corporation's stock. From its 1958 price of $15, which was just about 10 times its $1.56 earnings of that year, the stock skyrocketed to $80 -- at which point it was selling at an almost unbelievable 37 time its latest year's earnings. Put another way, the price of the stock rose a fantastic 433% while earnings were increasing 37%.

Even today, after the recent market drop, Chock Full O'Nuts is selling at $70, which is still a cool 33 times earnings. Moreover, at $70 a share -- the Company's indicated market value on its 848,730 shares outstanding is almost $60,000,000, or just about 8-1/2 times its balance sheet net worth of $7,000,000.

The investing public has - quite obviously - "tagged" Chock Full O'Nuts a "super-growth stock", otherwise it wouldn't be selling at 33 times its latest earnings. As we see it, however, "Chock Full" has gone about as far as it is reasonable to expect it to go in raising its after-tax profit margin which is now a truly remarkable 6% (twice Stouffer's 3%, and 3-1/2 times Shattuck's 1959 figure of 1.7%), and from now on must depend on a very considerable expansion in its sales volume if it is to boost its earnings to a level more in keeping with the price of its stock.

Now let's talk about Frank G. Shattuck Company (better known as Schrafft's) whose stock is selling around the price at which Chock Full O'Nuts was sold to the public two years ago. We suggest this - not because we expect Shattuck to duplicate Chock Full's spectacular market performance, but because we believe Shattuck today is a far different Company than it was only a few short years ago, and will change even more in the next few years.

To start off, we should point out that at today's prices - $70 will buy just 1 share of Chock Full O'Nuts, whereas the same $70 will buy 4.4 shares of Shattuck at its current price of about $16. Here are the relative values involved:

	1 Share "Chock Full" at $70 Represents	4.4 Shares of Shattuck Represents	
Net Asset Value	$ 8.24	$ 88.00	(Shattuck's net asset value is $20)
Sales	33.00	246.00	(" '59 sales were $56 per share)
Profit	2.14	4.14	(" '59 profit was 94¢ per share)
Dividend	1.40	2.20	(" dividend is 50¢ a share)

Summing up these figures, here's what they show. A person investing $70 in Shattuck (4.4 shares x $16) gets 10 times as much total asset value as he would receive on one share of "Chock Full"; 7 times as much sales volume; about twice as much in earnings; and about 60% more dividend income. By themselves, these figures make a rather compelling case for buying Shattuck, but the

(over please)

[fol. 68]

October 14, 1960

comparisons - as favorable as they may appear for Shattuck - are not the only basis for this report. Actually, all these figures do is emphasize the point that for the amount of capital it has had at work, and the enormous edge it enjoys in sales, Shattuck's earnings and dividends in recent years have been way, way below what they really should have been. <u>This, however, is a condition we believe is now clearly on its way to being corrected</u>.

What most investors may overlook in studying the Shattuck picture is that while its sales in the past three years have risen about 20% (from $51.6 million in 1956 to $61.7 million in 1959), its after-tax profit margin has been moving up from 1.1% to 1.7%, an increase of 54%. <u>As a starter</u>, this improvement in Shattuck's profit margin is good, but we think the Company should be able to earn at least 3-1/2% on sales ... <u>a figure</u> that, coupled with an expected increase in sales of 10% a year, should mean a doubling - or even trebling - of Shattuck's 1959 earnings of 94¢ a share over the next few years.

SHATTUCK (FRANK G.) COMPANY

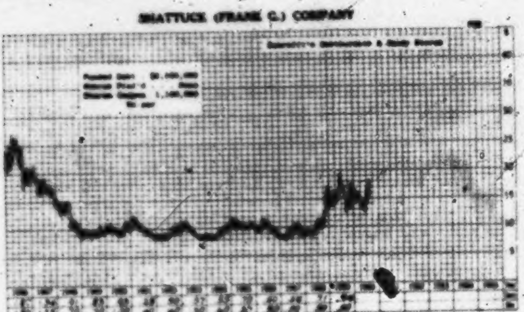

Chart used thru courtesy of M. C. Horsey & Co., Publishers

A look at the accompanying chart shows that for almost <u>10</u> years, from 1949 thru most of 1958, Shattuck's stock never "strayed" outside the $8/$12 zone, for the very good reason that its profits were making absolutely no headway. Then in late '58 the stock perked up, and by mid-'59 reached $19-1/4 - a figure it hadn't seen since 1947. What sparked the spurt? Surely it was something more important than the 22% increase in profits in 1958 over those of 1957, and the 32% increase in 1959 over 1958.

What "sparked the spurt", in our opinion, was the Company's decision to start capitalizing <u>as it never had before</u> on its most priceless asset ... and all that it stood for in quality, excellence, and public acceptance ... the name <u>Schrafft's</u>. With its famous ice-cream, its nationally distributed line of Schrafft's candy, and its 54 <u>restaurants</u> and retail stores in New York, Boston, Cambridge, Mass., Syracuse, N.Y., Newark and Philadelphia, few Companies were as well situated as Shattuck to branch out into many other phases of the food business here, there, and everywhere.

One of its most important recent moves has been to offer a wide range of its food products in selected supermarket outlets. Operating its own "Schrafft's Quality Isles" in these supermarkets, each location is attended by a uniformed hostess-manager. Around 25 of these "store within a store" units are already in operation. Although "starting-up" expenses for these new installations are large, long range benefits to sales volume and profits are expected to be substantial.

Now the Company has embarked on a franchise program under which a large number of America's finest motels will have an opportunity to use the well-known Schrafft name for their restaurants. These restaurants will be under the complete supervision of a Schrafft's manager, <u>and Schrafft's recipes and products will be used exclusively</u>. For these services, Shattuck will receive a percentage of gross receipts. A half dozen of these are already in operation, or will be very shortly, and many more are expected to follow.

Due to open its <u>first</u> restaurant in Florida this coming winter, the Company is now embarked on a vigorous program of expansion that should prove most rewarding to those who are able to accumulate its stock around current levels. Of the 1,100,000 shares outstanding, incidentally, management owns or controls an estimated 50% ... a "stake" worth close to $10 million, even at today's market.

H. P. Schwarzmann

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CGRB

CAPITAL GAINS RESEARCH BUREAU, Inc.
Registered with the Securities & Exchange Commission as Investment Advisers

special bulletin

Larchmont, New York • Telephone TEmpson 4-7150 November 1, 1960

"THE AVERAGE COST OF MOVING A TON OF FREIGHT ONE MILE IS 6¢ BY TRUCK, 24¢ BY AIRPLANE, AND LESS THAN 1-1/2¢ BY EFFICIENT, LOW-COST RAILROADS". . . . . .

So reads a full page ad of the Association of American Railroads in the October 31 issue of TIME magazine.

This thought-provoking ad caught our eye on the same day that Union Pacific released its figures for the first nine months of this year which showed a drop in profits of less than 5% from those of a year ago . . . despite a drop in the price of its stock of 34% from last year's high of $38-3/8.

Adding significance to the TIME ad, and the Company's nine-month report, was still another meaningful development . . . the fact that in the September quarter the giant Massachusetts Investors Trust (assets $1.4 billion) picked up another 34,000 shares of U.P. to bring its total holdings to 525,000 shares, a "package" worth $13,125,000 even at today's depressed price of $25. (Important to note is that this was the fifth quarter out of the past six in which M.I.T. has been a buyer of U.P., during which period it increased its holdings by a total of 165,000 shares.)

Acknowledged to be one of the strongest, best situated, and best managed railroads in the country . . . with an uninterrupted dividend record going back 60 years . . . U.P. is unique in the railroad field in the sense that it depends upon its railroad operations for less than half of its net income - as witness this breakdown of its nine months' figures:

	1960	1959
Transportation Profits	$22,290,948	$26,585,269
Income from Investments	9,557,884	7,170,324
Oil & Gas Income	14,721,017	14,838,133
Totals	$46,569,849	$48,593,726

Study these figures carefully, because they point up something that we believe is overlooked by investors who are dumping their U.P. when, instead, they really should be buying it like shrewd old M.I.T. Even if the railroads were "going out of style" (an absurd and overly pessimistic thought if you catch the full meaning of the TIME ad) how can one classify U.P. as "just another railroad" when $24.3 million of its 9 months' profit of $46.6 million came from other activities?

Over the past 10 years U.P. earned an average yearly profit of $3.09 a share, and in the present year is expected to show about $2.75, or a few pennies more than last year's $2.71. Present dividend, which has been in effect since 1955, is $1.60 a share, to show a yield of 6.4% at $25.

With a $143,000,000 investment portfolio (including 716,440 shares of Illinois Central) and an estimated 7,000,000 acres of land in the west, Union Pacific makes real investment sense at its current price of $25, which is only $5 a share above its $20 low for the past 10 years.

Among the 75 Funds in America with individual assets of over $50,000,000, 16 owned a total of 1,070,441 shares of U.P. as follows: Adams Express - 10,000; Affiliated Fund - 137,000; Axe-Houghton "B" Fund - 12,000; Financial Industrial Fund - 31,000; Group Securities (Common Stock Fund) - 8,000; Hamilton Funds - 34,000; Investors Mutual - 115,000; Massachusetts Investors Trust - 525,000; Massachusetts Life - 9,000; United Accumulative - 40,000; United Income - 30,000; Value Line Income - 29,300; Eaton & Howard Balanced - 22,000; Eaton & Howard Stock Fund - 27,000; International Holdings - 6,700; and Founders Mutual - 34,441.

H. P. S.

[fol. 71]

IN UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Civil Action No. 60 CIV 4526

[File Endorsement Omitted]

[Title Omitted]

ANSWER—filed March 25, 1961

The defendants, answering the complaint, deny each and every allegation contained in paragraphs numbered 1, 2, 7, 8, 9, and 10.

FIRST DEFENSE

The complaint fails to state a claim against defendants upon which relief can be granted.

WHEREFORE, defendants pray that the action be dismissed with costs and disbursements of the action.

FENNELLY, DOUGLAS, EAGAN,
NAGER & VOORHEES,
Attorneys for Defendants,

/s/ By: Leo C. Fennelly
LEO C. FENNELLY
Office and Post Office Address
20 Exchange Place,
New York 5, New York.

[fol. 72]

AFFIDAVIT OF SERVICE BY MAIL
(omitted in printing)

[fol. 73]

IN UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 30—September Term, 1961.

Argued October 13, 1961.

Docket No. 26942

SECURITIES AND EXCHANGE COMMISSION,
Appellant,

—v.—

CAPITAL GAINS RESEARCH BUREAU, INC.,
and HARRY P. SCHWARZMANN,
Appellees.

Before:

CLARK, WATERMAN and MOORE,
Circuit Judges.

Appeal from an order of the District Court for the Southern District of New York, Edward J. Dimock, *Judge*, which denied plaintiff-appellant's motion for a preliminary injunction to restrain defendants-appellees from alleged violations of the Investment Advisers Act of 1940 (15 U. S. C.A. 80b-6(1) and (2)).

Affirmed.

[fol. 74]

ALLAN F. CONWIL, Washington, D. C. (Peter A. Dammann, General Counsel, Ellwood L. Englander, Special Counsel, Walter P. North, Assistant General Counsel, Ned B. Stiles, Attorney, and John Frohling, Attorney, Securities and Exchange Commission, Washington, D. C., on the brief), *for appellant.*

LEO C. FENNELLEY, New York, N. Y, (Fennelly, Douglas, Eagan, Nager & Voorhees, New York, N. Y., on the brief), *for appellees.*

OPINION—December 18, 1961

MOORE, *Circuit Judge*:

Plaintiff (appellant), Securities and Exchange Commission (SEC), in its complaint, alleging violations of Section 206 (1) and (2) of the Investment Advisers Act of 1940, 15 U. S. C. A. 80b-6(1) and (2), sought a temporary restraining order, preliminary injunction and final injunction against defendants (appellees), Capital Gapital Gains Research Bureau, Inc. and Harry P. Schwarzmann, to prevent them from employing "any device, scheme or artifice to defraud any client or prospective client" and from engaging "in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." By order to show cause based upon the complaint and an affidavit of an SEC investigator, a temporary restraining order was granted and a hearing upon an application for a preliminary injunction was directed. No additional proof was offered by the SEC upon the hearing; Schwarzmann, as owner of Capital Gains and as a defendant, submitted an affidavit opposing the application. The District Court upon this proof denied the motion for a preliminary injunction and vacated the stay. The SEC appeals.

[fol. 75] Injunctive relief before a trial on the merits should be granted most sparingly and only upon convincing proof that irreparable injury will be caused unless the

courts stay the defendants' conduct. Furthermore, the courts generally will not grant a preliminary injunction when the effect thereof will be to give the applicant all the relief to which he would be entitled if successful upon the final injunction trial.[1]

Applying these principles to the facts, the conclusions are inescapable that the SEC did not meet the "convincing" proof standard and that a preliminary injunction for all practical purposes would have given to the SEC all that it could have received by final injunction after trial.

Section 206 declares that it is unlawful for any investment adviser (1) "to employ any device, scheme or artifice to defraud any client or prospective client" or (2) "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Fraud is the keynote of these provisions and the burden placed upon the party alleging fraud is that it be established by "clear and convincing"[2] proof.

[fol. 76] The only question presented upon appeal at this stage of the proceedings (namely, in advance of a trial upon the merits) is whether the facts were so clear and convincing that fraud and deceit were being practiced upon defendants' clients that the District Court abused its discretion in not granting a preliminary injunction

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[1] *W. A. Mack, Inc.* v. *General Motors Corp.* (7th Cir. 1958), 260 F. 2d 886;
Foundry Services v. *Beneflux Corp.* (2d Cir. 1953), 206 F. 2d 214, 216;
Selchow & Richter Co. v. *Western Printing & Lithographing Co.* (7th Cir. 1940), 112 F. 2d 430, 431;
United States v. *Adler's Creamery* (2d Cir. 1939), 107 F. 2d 987, cert. denied, 311 U. S. 657, (1940);
Gross v. *Kennedy*, 183 F. Supp. 750, 757 (S. D. N. Y. 1960);
Carey v. *General Electric Co.*, 165 F. Supp. 127 (S. D. N. Y. 1958);
Dressler v. *Wilson*, 155 F. Supp. 373, 376 (D. D. C. 1957).

[2] *United States* v. *Thompson* (10th Cir. 1960), 279 F. 2d 165, 167, wherein the court referred to "the spirit of the long accepted rule of law that one who asserts fraud has the burden of proving it by clear and convincing evidence." See also 9 WIGMORE, EVIDENCE § 2498 (3d ed. 1940).

and in preferring to await the development of all the facts upon a trial before decreeing drastic injunctive sanctions.

Capital Gains publishes an investment advisory service. It distributes two bulletins, one entitled "Facts on the Funds" (not involved in this proceeding), which informs subscribers as to changes in the portfolios of Mutual Funds and another headed "Special Recommendation" or "Special Bulletin" which gives financial facts and figures concerning the specific company made the subject of the analysis. Only certain bulletins involving the special situations are before the court.

The SEC did not present in support of its application for a preliminary injunction any of the reports upon which it relied as showing a failure to disclose material facts. However, this deficiency was remedied by defendants who attached the special bulletins to their answering affidavit. In substance, the bulletins contain figures showing the corporate earnings over a period of years of the companies therein analyzed, an outline of the nature and current status of the business, future prospects, earnings and price-to-earnings ratios, (in some cases) the number of Funds which own the stock, and usually a brief resume of assets and profits.

All seven companies[3] analyzed are substantial companies in their respective fields and their stocks have been listed and traded on the New York Stock Exchange for [fol. 77] many years. No charge is made by the SEC that any misstatements or false figures were contained in any of the bulletins; that the investment advice was unsound; that defendants were being bribed or paid to tout a stock contrary to their own beliefs; or that these bulletins were a scheme to get rid of worthless stock. The SEC premises its entire case upon the fact that shortly before the bulletins were mailed, defendants, consistent with their forthcoming recommendations, purchased shares of the stock and, in one instance where they suggested that the stock was too high, sold short. The SEC then points to the facts that there were small market rises in each of the stocks

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[3] Continental Insurance, Creole Petroleum, Union Pacific, Hart, Schaffner & Marx, United Fruit, Shattuck and Chock Full O'Nuts,

following publication and that defendants sold the stocks previously purchased (or covered as to the short sale) by them within a week or two thereafter. Thus, the SEC by its own fiat would create a law not enacted by Congress or a regulation not promulgated by the SEC to the effect that the failure to disclose to clients to whom purchase was recommended that they (defendants), too, had made purchases, constituted a scheme to defraud by failing to disclose a material fact. But what is the "material fact"? The SEC does not and cannot argue that it consists of a belief that the stock was a "sell" instead of a "buy" because there is no proof of any such belief. Furthermore, the action of defendants was consistent with their recommendations and belies such an inference. Of the seven stocks involved, the purchases (or in one case the short sale) in most instances were made just three to seven days before the reports containing the recommendation were mailed to the clients. Thus it would appear that the purchases were the result of the forthcoming recommendations. Certainly without any supporting proof a conclusion would not be justified that the recommendations were [fol. 78] made to enable defendants to unload their own recently acquired and comparatively small holdings.

Presumably the SEC relies upon the defendants' subsequent sales as implying a belief that the stock analyzed was not a good purchase to be held more than six months. But even a then present intention to sell shortly after publication will not support an inference that the recommendation to others to buy and hold for the capital gains period was fraudulent or deceptive. And if this be the material omission, what is the remedy? A mere statement in the bulletins that defendants also owned certain shares would accomplish nothing. Thousands of other persons owned shares of the same companies. A statement that defendants intended to sell within two weeks would not be accurate because their intention to buy, sell or hold could be determined only in the light of then unknown events. If the market were strong, they might wish to take a small profit on an "income" tax basis or hold for the six months capital gains period; if the market were weak they might wish to limit their losses by selling or holding for a longer period, hoping for a recovery. Surely, no one could be so

naive as to believe that a small advisory service with only 5,000 subscribers could by its own recommending influence cause such stocks as Union Pacific (22,000,000 shares outstanding), Continental Insurance (12,000,000 shares outstanding) and United Fruit (8,730,000 shares outstanding)[4] invariably and automatically to rise so that defendants could always sell their small holdings at a small profit. In the one instance, Hart, Schaffner & Marx, where the company had less than one million shares outstanding, the clients were told that purchases were recommended "around the $23-$24 level" (the then current price). Such advice would hardly be consistent with an inference that [fol. 79] it was intended thereby to raise the market price by their own clients' buying power. Moreover, it is significant that the SEC introduced no proof that any client ever purchased any shares of the recommended securities. The SEC's conclusion that these particular 5,000 subscribers must have rushed in, thereby creating an artificial stimulant, is wholly speculative and is at variance with common sense. Consider realistically the buying power which comes from pension funds, investment trusts, university and hospital endowments, foundations, insurance companies and some 180,000,000 citizens with their millions available daily for investment. In the light of such a situation, the comparatively few shares out of 22,000,000 (Union Pacific) that Schwarzmann's clients might have ordered would have been as the proverbial grain of sand is to the beach. And flattering though it might be to Schwarzmann, would anyone believe that his recommendation would stem the tide of decline if some pessimistic world event were simultaneously announced, some Mutual Fund chose to sell or an estate had to be liquidated?

The SEC contends that present intent to sell a stock in the near future if it rises must be accepted as conclusive proof that the advice to buy was dishonest and fraudulent. However, do not the vast majority of those who buy hope to sell at some time at a profit? When the sale will take place can be determined only by considerations personal to each purchaser. His own financial needs, his trading policy, his habit of accepting small profits or

[4] Approximate figures.

his policy of buying for the so-called long pull will control his actions. Of necessity, every purchase and sale transaction involves diametrically opposed thoughts by two individuals concerning the same stock but this does not create fraud and deception so long as false facts and figures have not motivated their action.

[fol. 80] The result reached by the District Court in no way weakens the praiseworthy role of the SEC in its vigilant protection of unwary investors. The SEC correctly argues that federal securities laws are to be construed broadly to effectuate their remedial purpose. Nor can there be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised. A good example of a violation of this principle is found in *SEC* v. *Torr*: [5]

> When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived.

Another illustrative situation is in *Ridgely* v. *Kean*, 134 App. Div. 647, 119 N. Y. S. 451 (1909), where an investment adviser failed to disclose that he was being paid to tout a stock.

The SEC'S exception to the District Court's comment that there is no proof that any client lost any money by reason of defendants' acts is also well taken. The test is not gain or loss. It is whether the recommendation was honest when made.

The many cases cited by appellant and appellees are not germane to a resolution of the problem here presented. For the most part, they deal with the purchase and sale of securities by or through brokers where inside or so-called confidential information was possessed by one party to the transaction which was not disclosed to the other. These

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[5] 15 F. Supp. 315, 317 (S. D. N. Y. 1936), rev'd on other grounds (2d Cir. 1937), 87 F. 2d 446.

[fol. 81] situations are typified by the recent decision of the SEC in *"In the Matter of Cady, Roberts & Co.*—No. 8-3925" (Nov. 8, 1961) wherein a broker having received advance notice of a substantial reduction in a company's dividend sold large quantities of the stock to purchasers who had no knowledge of the dividend cut and who undoubtedly would not have purchased (at least at the then quoted price) had they known the facts.

Nor is the decision of the District Court in any way at variance with the salutary purpose of the Investment Company Act of 1940 or the Investment Advisers Act of 1940. This court said in *Charles Hughes & Co.* v. *SEC* (2 Cir. 1943), 139 F. 2d 434, "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do * * *" (Clark, C.J.). And so it is. However, each case must be judged upon its particular facts after a full and fair hearing and not upon unwarranted inferences.[6]

In final analysis what the SEC would have the court do here is to create a law which Congress has never enacted or a regulation which the SEC has never promulgated which, in effect, would prohibit investment advisers or their employees from purchasing or selling any of the many stocks covered by their services. Any such drastic legislation or regulation should be enacted only after hearings upon which the need, if any, for any such remedial legislation can be explored and all interested parties given an opportunity to be heard. Any such regulation should come only as suggested by the Supreme Court in *Miner* v. [fol. 82] *Atlass*, 363 U. S. 641, 650 (1960) with respect to procedural innovations "only after mature consideration of informed opinion from all relevant quarters, with all the opportunities for comprehensive and integrated treatment which such consideration affords."

[6] See *Hughes* v. *Treat*, 22 S. E. C. 623 (1946), where the proceedings were dismissed on the facts; Litigation Release 372 on *SEC* v. *Todd*, cited in 3 LOSS, SECURITIES REGULATION, 1516, n. 122 (2d ed. 1961), where although the defendant had originally consented to an injunction, it was vacated without objection by the SEC in order to permit a trial on the merits and eventually the SEC agreed to a dismissal because the provable facts would not have supported an injunction.

The benefits to be derived by the investing public, who otherwise would have no adequate basis for forming an opinion, as a result of receiving advice honestly given based upon the analysis of financial experts, scarcely can be doubted. A senior financial statesman, Bernard Baruch, has said:

> What of the man or woman with modest savings who is simply looking for a fair return on his or her savings and who cannot give full time to a study of investments? My advice to such persons is to seek out some trusted investment counselor.[7]

Congress and the SEC have been watchful of the interests of the investor. In September, 1960, Section 80b-6 was amended and subparagraph (4) was added (74 Stat. 887, P.L. 86-750 § 9) giving to the SEC the power to "by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." As stated in Senate Report No. 1760, June 28, 1960 (the Senate bill was passed), "This provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients." Acting thereunder the SEC in August, 1961, published its revised proposal to adopt its first Rule (Rule 206(4)-1) which declared certain advertisements by investment advisers to be fraudulent, deceptive or manipulative within the meaning of Section 206 [fol. 83] (4) of the Act. The SEC invited comments and suggestions on the proposals and after careful consideration thereof adopted a Rule, effective January 1, 1962. The stated and obvious purpose of the future date was to give persons and companies affected thereby an adequate opportunity to know the prohibition before they were condemned for violating it. (See, SEC Release No. 121, Nov. 2, 1961.) The same charge of fraud and deception might have been made against previous advertisements because it is common knowledge that for decades the public press has carried advertisements of investment advisory or stock

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[7] BARUCH, MY OWN STORY (1957).

trading services that listed their profitable selections and minimized or omitted their less successful recommendations. Believing that such advertising is deceptive and misleading, the SEC directs its discontinuance. But believing equally in fair play, the SEC affords a reasonable opportunity for compliance rather than seeking an immediate injunction against the advertising now in effect.

It is most significant that there is no statute, rule or regulation against any investment advisory service owning any shares of any security recommended or against the purchase or sale of any such shares within a specific period of time before or after publication. Whether such a rule would be in the public interest is not for judicial legislation or adjudication. The SEC has been charged by Congress with the making of such rules. The SEC has evinced a wise policy of promulgating its rules only after a careful study of all the facts, the holding of hearings, the weighing of testimony from interested parties, and consideration of comments and suggestions. Hundreds of individuals and companies are engaged in the business of investment advisers. What is the impact, if any, on the market of the investment advice of any one bulletin? Of what influence, if any, is the number of subscribers (1,000 or 50,000)? What if one service recommends the sale of a certain stock simultaneously with the independent [fol. 84] recommendation of another service to purchase the same stock?[8] Is fraud to be presumed; and, if so, by which service? Countless other questions suggest themselves with which, if there be any need for regulation or control, the SEC will have to cope. For the present and until the facts are fully developed, it seems appropriate that the courts in piecemeal fashion do not try to take over the regulatory function of the SEC and single out a rather small advisory service and hold it in advance of trial responsible for violation of a rule which has not yet been

[8] The daily press and financial journals in reporting upon changes in Mutual Funds portfolios frequently disclose that the business judgment of one Fund dictated the sale of a certain stock at approximately the same time that another Fund considers the same stock an advisable purchase.

promulgated and as to which there is no certainty that it ever will be.

The order denying a preliminary injunction is affirmed.

WATERMAN, *Circuit Judge:*

I concur in the result.

CLARK, *Circuit Judge* (dissenting):

It can be demonstrated, I believe, that my brothers here have given a uniquely restrictive interpretation to the Investment Advisers Act of 1940—the last of the six great regulatory statutes governing dealings in investments—contrary to the general judicial approach to these statutes. But before I discuss this troublesome ruling I think I should note the unfortunately wide scope of the decision and its public importance. For it endorses and in effect validates a distressingly low standard of business morality. Cutting through all the procedural steps and noting the denial of the very mild and nonpunitive remedy of an injunction only preventing future violations, I find it all too clear that the opinion here, re-emphasizing the opinion below, has found nothing objectionable, much less illegal, in an investment adviser—a business fiduciary according [fol. 85] to the intent of the regulatory statute—making substantial profits by secretly playing the market contrary to his advice to customers. I suspect the license thus granted is one the top advisers—those who are trusted by the banks, the insurance companies, and the investors generally—not only do not desire, but find rather shocking, in the doubt thus cast upon the good faith and loyalty of all of their profession. For all are thus reduced, in the eyes of the law, to the standards of the lowest.

While the over-all trend of the decision is thus obvious, the opinion does not make the facts or the law sufficiently clear to clarify the central legal issue. Actually the facts are substantially not in dispute; and the issue is whether the prohibitions of the Act, particularly those which prohibit engaging in any course of business "which operates as a fraud or deceit upon any client or prospective client," 15 U. S. C. § 80b-6(2), are limited strictly to common law fraud, as the district court held, or express a wider fiduci-

ary obligation of full disclosure of conflicting ties and full loyalty to the client's interest. As to the facts the S.E.C. —with commendable expedition and zeal, considering all the ramifications of its far-ranging tasks and the difficulties of detection generally—uncovered a half-dozen cases of private stock dealings by defendant Capital Gains at the behest of its sole stockholders and owner, Schwarzmann. These the Commission quite properly accepted as a pattern of defendants' normal activities, sufficient upon which to base a prayer for a preventive remedy for the future. The pattern was that Capital Gains would privately buy some well known stock for its private account, that it would describe the stock favorably in its bulletin "Special Recommendation" or "Special Bulletin," distributed to its 5,000 subscribers and frequently quite widely to the public on a mailing list of about 100,000, and that then in a few days, perhaps a couple of weeks or less, [fol. 86] when the market price of the stock had risen, it would sell out, pocketing the gain. Apparently it did not look for spectacular market swings, but nevertheless it was able to achieve fairly steady profits from this course of dealings. In one spectacular case it combined this scheme successfully with the short selling of a stock it then proceeded to decry in its report as over-priced.

Defendants did not deny these specific instances, but attempted to play them down, stressing particularly that their operations were too small to cause the market swings and that their clients did not lose because the stocks were good investments. Of course it is difficult to tell surely what will cause a good stock to go up a few points; but it seems likely that concentrated buying may have some effect, and it is significant that in each case the market did actually respond in the way desired. But this defense, which has been fully accepted by my brothers, completely misses the point. A first duty of a fiduciary is loyalty to his beneficiary; if he is engaged in feathering his own nest, he cannot be giving his client that wholly disinterested advice which it is his stock in trade to provide. My brothers appear to assume that the practices indulged in by the defendants here are quite widespread on the part of investment advisers. There is not a bit of evidence before us to this effect, and personally I do not believe it

for a minute. But further it appears quite clear that it was the purpose of the legislation to outlaw and stop such practices.

The history of this legislation shows a Congressional intent to establish a fiduciary relationship on the part of the adviser to his client; it also shows a purpose to safeguard bona fide investment counsel against the stigma of the activities of unscrupulous tipsters and touts. This is convincingly traced by the leading academic authority in the field, 2 Loss, Securities Regulation 1392 *et seq.* (2d [fol. 87] Ed. 1961). It is quite obvious that this broad and complete supervision of the adviser who was required by the Act to register would be quite frustrated if the Commission had to show at every step common law fraud, including intentional misrepresentation to a specific person to his individual loss. Actually there is convincing evidence to the contrary. As Professor Loss, after quoting the two subsections relied on by the Commission, § 206(1) and (2), 15 U. S. C. § 80b-6(1) and (2), points out: "These clauses are modeled on Clauses (1) and (3) of § 17(a) of the Securities Act [15 U. S. C. § 77q(a)(1) and (3)]. Consequently, everything which has been said thus far in this chapter applies with equal force to investment advisers *mutatis mutandis.*" 3 Loss, Securities Regulation 1515 (2d Ed. 1961). This carries his discussion back to his earlier detailed consideration of SEC "fraud" concepts going well beyond circumstances giving rise to a common law action of deceit. 3 Loss, Securities Regulation 1430, 1435, 1474 (2d Ed. 1961), with citation of cases such as *Charles Hughes & Co.* v. *S. E. C.*, 2 Cir., 139 F. 2d 434, 437, certiorari denied 321 U. S. 786; *Hughes* v. *S. E. C.*, D. C. Cir., 174 F. 2d 969; *Norris & Hirshberg, Inc.* v. *S. E. C.*, D. C. Cir., 177 F. 2d 228, and other cases cited in 3 Loss, *id.* 1435 n. 19. A fiduciary who recommends the purchase of a particular stock because or after he has secretly taken a position in that stock which will make his recommendation profitable for him is guilty of deception if he conceals the secret motive underlying his advice. Indeed, this appears to be the law even without statute. *Ridgely* v. *Keene*, 1909, 134 App. Div. 647, 119 N. Y. S. 451, 453.

In 1960, upon recommendation of the SEC and with the announced purpose of tightening up the Act, a series of

amendments were passed. 2 Loss, *id.* 1395; 3 Loss, *id.* 1515-1518. There was then added to this statute by amendment of Sept. 6, 1960, 74 Stat. 887, a fourth paragraph, 15 U.S.C. § 80b-6(4), which is important enough [fol. 88] here to quote: "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Since most of the events here involved took place before the statute became effective, the SEC has not relied on it to sustain the requested injunction, though it would seem that the first sentence could be cited to support the prospective remedy here sought which operates only in the future. It should be particularly noted that the provision adds powers and terms of regulation; it nowhere cuts down or reduces them.

Curiously enough my brothers seize upon this statute to cut down the clear grant of authority expressed in words already defined in the earlier statutes. While seemingly agreeing that the new statute gives the Commission the authority to proceed against practices of the general type here involved, they state that this authority cannot be exercised until a specific rule outlawing this precise behavior has been promulgated. But the statute is eloquently silent as to any such condition, and is in terms broadly prohibitive. And the argument misconceives the significance of the grant of rule-making power. It is Congress which declares the policy and defines the prohibitions, while the SEC is authorized to adopt regulations not to vary, but to aid in the execution of, the policy. Cf. *S. E. C. v. Chenery Corp.*, 332 U. S. 194. Here the SEC with commendable expedition, having in mind the necessity of extensive hearings and full consideration of the various interests needing to be heard, has substantially completed work upon at least preliminary regulations under this statute. It is to be noted that those already published seem [fol. 89] shrewdly framed in terms of ways and means for the better effectuation of the policy, rather than its

variation.[1] In my judgment, therefore, the new statute has been put to a wholly improper argumentative use; it supports rather than undercuts the Commission's position.

My brothers find various procedural objections to an injunction *pendente lite* here, citing a variety of legal clichés which have certain fields of operation, but which are quite inapposite here. Thus the injunction was not refused by the district judge as a matter of discretion weighing the equities; it was refused on the basis of an erroneous ruling of law, and a claim of right thereto by the defendants. Of course we must and do correct such mistakes as a matter of course on appeal from a denial of injunctive relief, see, e.g., *Ring* v. *Spina*, 2 Cir., 148 F.2d 647, 160 A. L. R. 371. Then there is the statement that a preliminary injunction should not grant what is being sought permanently. This means only that a case should not be prejudged prior to a full hearing beyond what is necessary fairly to preserve the parties' right. Of course it cannot mean—and this is belied in daily practice—that an injunction cannot issue when the plaintiff's right to ultimate relief is shown; that would be to say in effect that the better the plaintiff's case, the less chance he has for any remedy until a possibly protracted trial is completed. Here there is a strong public interest involved, both on the part of the investing public and on the part of other investment advisers whose reputation is being sadly traduced by the defendants' activities. On the other [fol. 90] hand, the defendants are little prejudiced by the non-punitive injunction sought, which merely directs them in the future to follow that course of conduct which they ought to wish to do anyhow, particularly if they would retain any shred of reputation as a trustworthy adviser. Further it will relieve this important commercial court of the stigma of supporting low business practices. The decision below should be reversed for the grant of an injunction *pendente lite*.

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[1] The opinion cites SEC Release No. 121, Nov. 2, 1961, dealing with fraudulent, deceptive, or manipulative advertising by investment advisers. It should have cited SEC Release No. 120, Oct. 16, 1961, requiring registration of stock dealings by advisers *and their staffs*. These proposed regulations are obviously means and devices to effectuate the declared policy of the statute, not to make different policy.

[fol. 91]

IN UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

* * * *

Present: HON. J. EDWARD LUMBARD, Chief Judge,
HON. CHARLES E. CLARK,
HON. STERRY R. WATERMAN,
HON. LEONARD P. MOORE,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,
HON. THURGOOD MARSHALL, Circuit Judges.

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLANT,

v.

CAPITAL GAINS RESEARCH BUREAU, INC.,
and HARRY P. SCHWARZMANN, DEFENDANTS-APPELLEES.

ORDER GRANTING PETITION FOR REHEARING IN BANC—
January 23, 1962

A petition for a rehearing in banc having been filed herein by counsel for the appellant

Upon consideration thereof, it is

Ordered that said petition be and hereby is granted.

Further ordered that oral argument will be heard on Thursday, February 22, 1962 at 11:00 A.M.

Further ordered that the parties may file additional briefs on or before February 13, 1962.

A. DANIEL FUSARO
Clerk

[fol. 92] [File Endorsement Omitted]

[fol. 93]

IN UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 30—September Term, 1961.

Rehearing en banc February 22, 1962

Decided July 13, 1962.

Docket No. 26942

SECURITIES AND EXCHANGE COMMISSION,
Appellant,

—against—

CAPITAL GAINS RESEARCH BUREAU, INC., and
HARRY F. SCHWARZMANN,
Appellees.

Before:

LUMBARD, *Chief Judge*, and
CLARK, WATERMAN, MOORE, FRIENDLY, SMITH,
KAUFMAN, HAYS and MARSHALL, *Circuit Judges.*

Appeal from an order of the District Court for the Southern District of New York, Edward J. Dimock, *Judge*, which denied plaintiff-appellant's motion for a preliminary injunction to restrain defendants-appellees from alleged violations of the Investment Advisers Act of 1940 (15 U. S. C. A. 80b-6(1) and (2)). Opinion below reported at 191 F.Supp. 897.

Affirmed.

[fol. 94]

DAVID FERBER, Associate General Counsel, Securities and Exchange Commission, Washington, D. C. (Peter A. Dammann, General Counsel, Ellwood L. Englander, Special Counsel, Walter P. North, Assistant General Counsel, Ned B. Stiles, Attorney, John Frohling, Attorney, and Allan F. Conwill, of Counsel, Securities and Exchange Commission, Washington, D. C., on the brief), *for appellant.*

LEO C. FENNELLY, New York, N. Y. (Fennelly, Douglas, Eagan, Nagar & Voorhees, New York, N. Y., on the brief), *for appellees.*

OPINION ON REHEARING IN BANC—July 13, 1962

MOORE, *Circuit Judge*:

Plaintiff (appellant), Securities and Exchange Commission (SEC), in its complaint, alleging violation of Section 206(1) and (2) of the Investment Advisers Act of 1940, 15 U. S. C. A. 80b-6(1) and (2), sought a temporary restraining order, preliminary injunction and final injunction against defendants (appellees), Capital Gains Research Bureau, Inc., and Harry P. Schwarzmann, to prevent them from employing "any device, scheme or artifice to defraud any client or prospective client" and from engaging "in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." By order to show cause based upon the complaint and an affidavit of an SEC investigator, a temporary restraining order was granted and a hearing upon an application for a preliminary injunction was directed. No additional proof was offered by the SEC upon the hearing; Schwarzmann, as owner of Capital Gains and as a defendant, submitted an affidavit opposing the application. The District Court upon this proof denied [fol. 95] the motion for a preliminary injunction and vacated the stay. 191 F.Supp. 897 (1961). The SEC appealed. A panel of this court affirmed the district court's

order. 300 F. 2d 745. A petition of the SEC for a rehearing *en banc* was granted.

The only question presented at this stage of the proceedings, namely, an application for a preliminary injunction in advance of a trial upon the merits, is whether a violation of section 206(1) and (2) has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial.

The SEC brings this proceeding under subsections (1) and (2) of Section 206. These subsections make it unlawful "(1) to employ any device, scheme, or artifice to defraud any client or prospective client" or "(2) to engage in any business which operates as a fraud or deceit upon any client or prospective client."

Capital Gains publishes an investment advisory service. It distributes two bulletins; one entitled "Facts on the Funds" (not involved in this proceeding), which informs subscribers as to changes in the portfolios of Mutual Funds and another headed "Special Recommendation" or "Special Bulletin" which gives financial facts and figures concerning the specific company made the subject of the analysis. Only certain bulletins involving the special situations are before the court.

The SEC did not present in support of its application for a preliminary injunction any of the reports upon which it relied as showing a failure to disclose material facts. However, this deficiency was remedied by defendants who attached the special bulletins to their answering affidavit. In substance, the bulletins contain figures showing the corporate earnings over a period of years of the companies [fol. 96] therein analyzed, an outline of the nature and current status of the business, future prospects, earnings and price-to earnings ratios, (in some cases) the number of Funds which own the stock, and usually a brief resume of assets and profits.

All seven companies [1] analyzed are substantial companies in their respective fields and their stocks have been

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listed and traded on the New York Stock Exchange for many years. No charge is made by the SEC that any misstatements or false figures were contained in any of the bulletins; that the investment advice was unsound; that defendants were being bribed or paid to tout a stock contrary to their own beliefs; or that these bulletins were a scheme to get rid of worthless stock. The SEC premises its entire case upon the fact that shortly before the bulletins were mailed, defendants purchased shares of the stock and, in one instance where they suggested that the stock was too high, sold short. The SEC then points to the facts that there were small market rises in each of the stocks following publication and that defendants sold the stocks previously purchased (or covered as to the short sale) by them within a week or two thereafter.

The SEC correctly argues that federal securities laws are to be construed broadly to effectuate their remedial purpose. Nor can there be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised. A good example of a violation of this principle is found in *SEC* v. *Torr*:[2]

> When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe
> [fol. 97] that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived.

Or if it were established that Capital Gains made its recommendations for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such conduct might well find itself within the prohibitions of Section 206(1) and (2).

But here the SEC's proof tends only to show that, at most, defendant Schwarzmann profited personally from the predictable market effect of his honest advice. There is no proof that defendants employed "any device, scheme or artifice to defraud any client or prospective client" or en-

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[2] 15 F. Supp. 315, 317 (S. D. N. Y. 1936), rev'd on other grounds (2 Cir. 1937), 87 F. 2d 446.

gaged "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC's case, both here and in the court below, has been based entirely upon section 206, subsections (1) and (2) of the Act. And in interpreting these sections we must take account of the recent warning of the Supreme Court against excessive judicial expansion of provisions of the securities laws to accomplish objectives believed to be salutary. *Blau* v. *Lehman*, 368 U. S. 403 (1962).

Although there is no direct occasion to consider whether defendants' activities were "manipulative" under the prohibition added to the Act by the Act of September 15, 1960, 74 Stat. 885, 15 U. S. C. § 80b-6(4), or could be prohibited by an SEC rule under that section, the amendment is not without significance. To section 80b-6 containing subsections (1) and (2) were added (3) (not here relevant) and (4) which made it unlawful for any investment adviser "to engage in any act, practice, or course of [fol. 98] business which is fraudulent, deceptive, or manipulative."

By the enactment of subparagraph (4), section 80b-6, the SEC now has been directed by Congress "by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." The SEC has not shown itself reluctant to consider and draft "rules and regulations" toward this end. Already it has issued regulations dealing with registration of stock dealings by investment advisers and their staffs and with types of advertising deemed to be fraudulent or deceptive. (See SEC Releases Nos. 120, 121, October 16, 1961, November 2, 1961.) The extent, if any, to which the SEC may believe it desirable to go in regulating purchasers or sales of securities by investment advisory publishers at or about the time of comment in their publications concerning such securities has been entrusted by Congress to the SEC. However, here the SEC's case is predicated solely on the deliberately meagre provisions of § 206(1) and (2) as enacted in 1940, 54 Stat. 853, and not on § 206(4) added by the Act of September 15, 1960, 74 Stat. 885. Whether

conduct such as defendant's is now forbidden as a "manipulative" practice under the first clause of (4) or only if prohibited by detailed rules and regulations promulgated by the Commission, is an issue neither presented nor determined.

The legislative history of the Investment Advisers Act strongly supports our interpretation of the language of subsections (1) and (2). The Investment Advisers Act of 1940 was not as comprehensive as the Securities Act of 1933 or the Securities Exchange Act of 1934. It did not have to deal with the purchase and sale of securities and broker-dealer-customer relationships. Rather the Act was thought to be a modest beginning—not a great and final [fol. 99] piece of legislation. "It followed a brief supplemental report on investment advisers which the Commission had filed as an incident of its investment trust study." Loss, "Securities Regulations," Vol. II, pp. 1392-1393. The report did not even propose legislation in any formal way, let alone define its scope. It merely described the investment counselling business in the United States and set forth state legislation on the subject, as well as showing how the Investment Counsellors of America regulated themselves internally. A representative of the SEC, testifying before the Senate committee in 1940, said the SEC knew very little about the investment-~~advertising~~ advising business and, therefore, the "fundamental approach" of the proposed legislation was to get a "compulsory census" of the industry. "Aside from that fundamental approach the only other provisions in that title are just a few broad generalizations which say that you cannot embezzle your client's funds or you cannot be guilty of fraud." Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580, pt. 1, 76th Cong., 2d Sess. (1940), p. 48. Hence, as Loss also tells us, "For twenty years this statute was little more than a continuing census of the Nation's investment advisers" until it "was substantially tightened up by a series of amendments in 1960, fifteen years after the Commission had first urged such action in a special report to Congress."

The history of the 1960 amendment confirms the narrow scope of the initial enactment, in an area highly relevant

here. This history begins with a report by the Senate Subcommittee on Legislative Oversight in which there was a short section on the Investment Advisers Act. This section says (p. 53 of the report):

> "Our recommendation that the act be amended arises from the fact that as shown in the hearings held September 17, 1958 (transcript, pp. 3753-3767), invest-
> [fol. 100] ment advisers are not now required to disclose the financial interest of affiliates in securities concerning which they give advice."

This conclusion had arisen from hearings on the Crowell-Collier issue of convertible debentures. An affiliate of the issuer was an investment adviser, and had recommended the issue without disclosing its interest. The Subcommittee commented (p. 54):

> "The failure to disclose to Investment Survey subscribers an obvious 'dual interest' with respect to Crowell securities did not constitute a specific violation of the act; see testimony by SEC personnel, transcript pages 3755, 3756."

The Subcommittee called for amendment of the act to make sure that such behavior would be a violation, quoting a statement of SEC Chairman, Edward N. Gadsby, that it was now time to strengthen the act to make it more than "a mere census taking." See Independent Regulatory Commissions, Report of the Special Subcommittee on Legislation Oversight of the Senate Committee on Interstate and Foreign Commerce, H. R. Rep. No. 2711, 85th Cong., 2d Sess. (1959), pp. 53-54.

The SEC staff prepared a memorandum describing the reasons for the various amendments that were being proposed in 1959. The section relating to the new subsection (4) for § 206, Hearings Before a Subcommittee of the Senate Committee on Banking and Currency on S. 1176, etc., 86th Cong., 1st Sess. (1959), pp. 516-517, reads in part as follows:

> "Section 9. Creation of rulemaking power over anti-fraud provisions:

[fol. 101] The substantive prohibitions of the Investment Advisers Act are very limited. They are in essence contained in sections 205 and 206, which outlaw certain types of unfair investment advisory contracts, and prohibit an investment adviser from perpetrating fraud or from selling securities directly to clients without disclosing the capacity in which he is acting and obtaining the client's consent.

Because of the general language of the statutory antifraud provision and the absence of any express rulemaking power in connection with them, the SEC has always had doubt as to the scope of the fraudulent and deceptive activities that are prohibited and as to how far it is limited in this area by common law concepts of fraud and deceit. These include proof of a (1) false representation of; (2) a material; (3) fact; (4) the defendant must make it to induce reliance; (5) the plaintiff must rely on the false representation; (6) and suffer damage as a consequence.

In order to overcome this difficulty, section 9 of the bill would amend section 206 to add a prohibition against engaging in conduct which is fraudulent, deceptive or manipulative and to authorize the Commission by rules and regulations to define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative. This is about the identical wording of section 15(c)(2) of the Securities Exchange Act in regard to brokers and dealers.

In the SEC's estimation, such a provision would enable it to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients."

[fol. 102] The committee reports show that Congress shared that assumption. The House Report, 86th Cong., 2d Sess. No. 2179, says the following:

"Section 9. Addition of rulemaking power to implement antifraud provisions:

Present law.—Present section 206 contains general prohibitions against fraudulent activities.

Problem.—Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit.

Remedy in the bill.—It is proposed that a new paragraph (4) be added to section 206 which would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of businesses which are fraudulent, deceptive, or manipulative. This is comparable to section 15(c)(2) of the Securities Exchange Act of 1934 which applies to brokers and dealers."

The Senate Report, No. 1760, U. S. Code Congressional and Administrative News 3502, accepts verbatim the SEC's reasons above quoted (p. 3509) and says generally that, "of the five acts administered by the Securities and Exchange Commission * * * the Investment Advisers Act of 1940 is the most inadequate," p. 3503. Coming to Section 9, it says this would authorize the Commission to issue regulations which would prohibit fraudulent, deceptive, and manipulative conduct," thereby affording a necessary supplement to the "very limited" provisions of §§ 205 and 206 which "outlaw certain types of unfair investment [fol. 103] advisory contracts, and prohibit an investment adviser from perpetrating fraud or from selling securities directly to clients without disclosing the capacity in which he is acting and obtaining the client's consent" (p. 3509). Finally, the report says, "This provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients" (p. 3510).

No proof having been presented under sections 206(1) and (2) sufficient to justify the granting of a preliminary injunction, the order appealed from is affirmed.

CLARK, *Circuit Judge*, whom Judges SMITH, KAUFMAN, and MARSHALL join, dissenting:

Decision in the present case turns on the meaning and scope of the Investment Advisers Act of 1940, last of the six great regulatory statutes of the era 1933-1940 controlling the marketing of investment securities. We need to recall the dramatic origin of these statutes as an outcome of the greatest stock market crash in history and the exhaustive studies then made of the evils of stock market manipulation and fraudulent stock selling. It seems universally conceded—and the favorable judicial attitude records the fact—that this legislation was brilliantly successful in responding to a genuine social need. It is a prime demonstration of the capacity of a democratic government to meet a social crisis skillfully and positively. While it may not have solved every problem, it went a long way in facing the issues involved and protecting the investor from being victimized.

After this history of successful achievement it comes as a real shock to find a majority of this court ready to scuttle the last of these highly useful statutes and leave it as [fol. 104] but a shell. In a summary opinion which ignores this history and the interconnection of these statutes, they officially declare this Act to be quite ineffective, thus terminating all present regulation of investment advisers and also casting doubt upon the other important acts framed in the same language. True, they pay verbal obeisance to the principle that these regulatory laws are to be construed broadly to effectuate their remedial purpose; in actual fact they cut down the operation of the Act's central provision, § 206, 15 U. S. C. § 80b-6, in the very area where its overall purpose might be furthered. Beyond this the majority show an antagonistic attitude toward securities regulation which bodes ill for the future effectiveness of even the earlier statutes, heretofore generously supported. I believe it fairly demonstrable that so destructive a decision not merely is not compelled, but actually is quite contrary to sound legal principles of statutory interpretation as we have up to now known them.

Initially I find it necessary to set out in greater detail than do the majority the substantially undisputed facts

upon which the SEC premised its complaint and motion for a preliminary injunction. Capital Gains Research Bureau, Inc., a leading registered investment advisory service, published two bulletins which it distributes to subscribers. One, entitled "Facts on Funds," explores changes effected in the portfolio of Mutual Funds; the other, "A Capital Gains Report," is a regular service which periodically evaluates securities. The Capital Gains Report is denominated: "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued." There are about 20,000 subscribers to the [fol. 105] "Facts on Funds" bulletin, and about 5,000 subscribers to the "Capital Gains Report"; the latter publication is frequently distributed to a large group of about 100,000 nonsubscribers by use of general mailing lists.

During the period covered in the complaint Capital Gains analyzed several securities and made recommendations to its subscribers concerning them. At the same time, without disclosing the transactions to its customers, it traded in these securities to its profit. The Commission contends that this pattern of secret trading violated the antifraud provisions of the Investment Advisers Act of 1940, § 206(1) and (2), 15 U. S. C. § 80b-6(1, 2). The transactions were as follows:

(1) On March 15, 1960, Capital Gains purchased 500 shares of Continental Insurance Co. stock at price of \$47¾ and \$47⅞ per share. Three days later it circulated a report recommending purchase of the stock "for gradual but substantial appreciation." For two days after the mailing of the report the volume of trading increased substantially and the market price rose, and on March 29 Capital Gains sold the stock at \$50⅛.

(2) Between May 13 and May 20, 1960, Capital Gains purchased 5,300 shares of United Fruit Co. stock, at a total cost of \$117,114.00. On May 27, a report was circulated recommending United Fruit for both long- and short-term gains. Again immediately following the mail-

ing date of the report, trading volume rose markedly and the price increased. (The average daily volume for 11 days preceding the issuance of the report was 5,955 shares; for the 4 days following, average volume was over twice this—13,150.) Between June 6 and June 10, Capital Gains sold the 5,300 shares at a profit of $10,725.00.

(3) On July 5 and July 14, Capital Gains bought 2,000 shares of Creole Petroleum. Then, on July 15, the com-[fol. 106] pany issued an optimistic report on Creole. Again volume increased immediately after the report, and again the price rose. Between July 20 and 22, Capital Gains unloaded its shares at a profit.

(4) On August 6, 1960, Capital Gains purchased 600 shares of Hart, Schaffner & Marx stock at $23. On August 12, it issued a report recommending purchase of this security. Again volume increased substantially following the issuance of the report, and the price rose. Within 10 days Capital Gains sold 600 shares at a profit.

(5) Between October 4 and October 13, Capital Gains entered into several transactions involving the stock of the Chock Full O'Nuts Corp. It sold 500 shares short at a net price of $34,200.00. It also purchased 11—3 month "puts." Like the short sale, the purchase of a put reflected a bet by Capital Gains that the price of the stock would decline in the period. On October 14, it sent to its subscribers and others a report comparing the value of Chock Full O'Nuts to that of Frank G. Shattuck Co. (Schrafft's). The report suggested that Chock Full O'Nuts was overvalued. Again, the day after the report was mailed volume increased and the price, which had been rising, fell and went into a decline; on October 24, Capital Gains covered its short sale at a profit.

(6) Finally, on October 28 and October 31, 1960, Capital Gains purchased a total of 2,000 shares of Union Pacific stock at a price slightly above $25 per share. On November 1, a report was issued recommending this stock. Once again, immediately following the mailing of the report, the volume increased markedly, and the price rose.

On November 7, Capital Gains sold the 2,000 shares at 27.[1] [fol. 107] Thus we have evidence of a practice known on Wall Street as "scalping," by which an investment adviser makes a short-term profit on the direct or secondary market reaction to its advice. The question for decision is whether this pattern of undisclosed purchases or short sales of securities shortly before recommendation, invariably followed by a rise in market volume and an appreciable rise or fall in price, followed shortly by sale or cover at a profit, constitutes sufficient evidence to warrant a finding of violation of the antifraud provisions of the Act. It is to prevent this practice that the SEC seeks the mild prophylactic of an injunction, without other penalties or sanctions.

Here there is no substantial dispute over the facts, and the injunction was denied solely because the district court believed that on these facts no violation of the Investment Advisers Act was made out. This was based on a seriously limiting interpretation of the antifraud provisions of the Act. Thus, as we have often ruled, we must grant full review of this legal determination at this time. See, e.g., *Ring* v. *Spina*, 2 Cir., 148 F. 2d 647, 650, 160 A. L. R. 371; *Carroll* v. *America Federation of Musicians*, 2 Cir., 295 F. 2d 484, 488-489; *Societe Comptoir de l'Industrie Cotonniere* v. *Alexander's Department Stores, Inc.*, 2 Cir., 299 F. 2d 33; *Empresa Hondurena de Vapores, S.A.* v. *McLeod*, 2 Cir., 300 F. 2d 222. It is not a question of finding defendants at fault without awaiting full development of the facts. The uncontroverted facts before us require determination of the scope of the Act. And this is what the [fol. 108] majority have done, for the denial of an in-

[1] While the evidence submitted was based on affidavits, the material facts were not denied by an answering affidavit. Here a detailed statement of a prolonged course of conduct was set forth by the Commission; the injunction was sought in the public interest by an independent regulatory body; and the affidavits were clearly sufficient to support a preliminary injunction. Of course the majority really do not deny this, for they accept the facts as stated in their determination of the merits of this appeal. The suggestion that the defendants had to supply the deficiencies of proof seems an unnecessary and irrelevant slur on the activities of a busy and overworked agency.

junction is grounded not on the state of the record, but on their view of the substantive scope of § 206.

As suggested above, it is necessary to view this legislation against its background, so totally ignored in the majority opinion. Faced with the great stock market crash and accompanying business depression, Congress reacted to the careful studies of stock manipulation before it by passing this series of six great regulatory acts for the protection of the securities investor. These were the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. These statutes form an interrelated pattern of regulation of the securities industry, all of which are essential for the adequate protection of the investor.

One of the chief methods of regulation followed in the several acts was the requirement of full disclosure. In contrast to the common law, which was premised on the ancient maxim *caveat emptor*, the regulatory legislation adopted the philosophy of consumer protection, "let the seller also beware." H. R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933), quoted in *Wilko* v. *Swan*, 346 U. S. 427, 430. Under this philosophy the seller of securities was required fully to disclose all relevant data, and a variety of devices was fashioned to achieve this end. For example, issuers must file detailed registration statements and circulate accurate prospectuses. Securities listed on an exchange must be registered and reports filed, and those soliciting proxies must disclose certain data. To stiffen and supplement these specific requirements, several antifraud provisions were enacted. Specific penalties and liabilities were provided for failure to disclose the required information. At the same time several general antifraud provisions were passed; among these were § 17(a) of the [fol. 109] Securities Act of 1933, 15 U. S. C. § 77q(a); §§ 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, 15 U. S. C. §§ 78j(b) and 78o(c)(1); and the sections here under consideration.

These general antifraud sections, which in substantive scope contain many similarities, have been liberally con-

strued to effectuate the broad remedial purpose of the acts. Section 17(a) has been held not to be limited to the narrow confines of common-law fraud. *Charles Hughes & Co.* v. *S.E.C.*, 2 Cir., 139 F. 2d 434, 435-436, certiorari denied 321 U. S. 786; see *Hughes* v. *S. E. C.*, D. C. Cir., 174 F. 2d 969, 974; *Norris & Hirshberg, Inc.* v. *S.E.C.*, D. C. Cir., 177 F. 2d 228; *Archer* v. *S.E.C.*, 8 Cir., 133 F. 2d 795, certiorari denied 319 U. S. 767; *S.E.C.* v. *Torr*, D. C. S. D. N. Y., 15 F. Supp. 315, reversed on other grounds 2 Cir., 87 F. 2d 446, reaffirmed on remand D. C. S. D. N. Y., 22 F. Supp. 602; 3 Loss, Securities Regulation 1435 (2d Ed. 1961). The common-law doctrines of fraud and deceit grew up in a business climate very different from that involved in the sale of securities, and the rigors of those doctrines were ill fitted to regulation of the sale of this unique and intricate merchandise. See generally Shulman, *Civil Liability and the Securities Act*, 43 Yale L. J. 227 (1933).

The Investment Advisers Act of 1940, the final step in the regulation of the securities market, reflects the purposes and policies of its predecessors. Thus the Senate Committee on Banking and Currency concluded: "The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale." Sen. Rep. No. 1775, 76th Cong., 3d Sess. 20 (1940).

[fol. 110] The majority present an extensive analysis of the "legislative history" of the Act to support their narrow construction of § 206. Very little of this is actually history; and some of that is, as I shall point out later, a misquotation of statements by Professor Loss. The remainder of the extensive discussion is not of history, but of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act. Not only are these citations misleading, but reliance on them violates canons of construction laid down by the Supreme Court.

The 1959 statements by the SEC do not support the majority's interpretation of the statute.[2] They do reflect some confusion and concern over the precise scope of § 206, but they never adopt the restrictive interpretation suggested. And it would be naive not to recognize that these statements were made at the close and under pressure of an era of limited initiative and retreat by the regulatory agencies.[3] Even if the SEC had by rule or regulation explicitly adopted a narrow construction of § 206, it would seem highly doubtful that it could thereby defeat the intention of the prior Congress. See *Greene* v. *Dietz*, 2 Cir., 247 F. 2d 689. *A fortiori*, expression of some hesitation or doubt in a later memorandum could hardly have such an effect. Cf. *Wong Yang Sung* v. *McGrath*, 339 U. S. 33, 47-48.

[fol. 111] Similarly, the opinions attributed to a Congress twenty years after the event cannot be considered evidence of the intent of the Congress of 1940. There is nothing in the extensive citations of the majority which indicates that the later Congress accepted a narrow interpretation of § 206. The reports merely echo SEC "doubts." Section 206(4), the 1960 amendment, utilizes language remarkably similar to that of the original statute; the chief material difference is the addition of rule-making power, and it may well be that Congress either rejected the doubts or held no views on the scope of the prior legislation. And even if Congress in 1960 had explicitly commented on the scope of the prior Act, its interpretation would be of little, if any, weight in determination of the

[2] Indeed, in 1955, the Commission argued that § 206, "enacted for the specific protection of the investing public," was definitely "not limited to the restrictive concepts of common law fraud." *Seipel* v. *S.E.C.*, D. C. Cir., 229 F. 2d 758, Brief for Appellee, p. 12. This argument was successful; the D. C. Circuit held that § 206 proscribed activity which would not have been actionable at common law. See 3 Loss, Securities Regulation 1516 (2d Ed. 1961).

[3] See, e.g., *Rosenblum* v. *F.T.C.*, 2 Cir., 214 F. 2d 338; *Blau* v. *Mission Corp.*, 2 Cir., 212 F. 2d 77, 81, certiorari denied *Mission Corp.* v. *Blau*, 347 U. S. 1016; *Roberts* v. *Eaton*, 2 Cir., 212 F. 2d 82, 84, certiorari denied 348 U. S. 827; *Greene* v. *Dietz*, 2 Cir., 247 F. 2d 689, 696.

meaning of the prior cognate legislation. *Rainwater* v. *United States*, 356 U. S. 590, 593. Thus the data marshaled by the majority prove no more than that a regulatory commission, perhaps sensing a favorable legislative climate, took an opportunity to secure fuller enforcement powers in order to simplify regulation. To determine the intention of the Congress of 1940 we must look backwards from the date of passage, not forwards.

The 1940 Act was designed to protect "the public" "from the frauds and misrepresentations of unscrupulous tipsters and touts" and to safeguard bona fide investment counsel "against the stigma of the activities of these individuals." Sen. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940). It required registration and prohibited investment advisers from engaging in certain conduct, including that defined in §§ 205 and 206. If, as the majority imply, the statute did not achieve its regulatory purpose, but remained "little more than a census," in Professor Loss's words, this was not due to any deficiency in the antifraud provisions here under consideration, which Loss concludes are very broad-reaching, 3 Loss, Securities Regula- [fol. 112] tion 1515 (2d Ed. 1961), but because until 1960 the Commission had inadequate power to inspect the books and records of advisers or to require reports, 2 Loss, Securities Regulation 1408 (2d Ed. 1961). As Professor Loss points out, "a statute of this sort without an inspection power is a statute without teeth." *Ibid.*

The antifraud sections of this statute are substantially similar to, or identical with, § 17(a) of the Securities Act of 1933, 15 U. S. C. § 77q(a), and, absent counterindications, should be construed *in pari materia*. Certainly with the earlier Acts before it, Congress would intend identical language to have identical import. Both outlaw use of a "device, scheme, or artifice to defraud" and acts which operate as a "fraud or deceit." Compare clauses (1) and (3) of § 17(a) of the earlier Act with clauses (1) and (2) of § 206 of the later Act. The sole substantial difference between the statute under review and its predecessor is that clause (2) of § 17(a) is not included in the later enactment. Even without explicit statement in the legislative history as to why this clause was omitted, the reasons seem obvious. This clause in essence restates

common-law deceit as it was defined in the most liberal jurisdictions, prohibiting obtaining money or property by misleading statements or omissions. See 3 Loss, Securities Regulation 1433-1435 (2d Ed. 1961). It was both necessary and natural to include such a provision in statutes regulating the activities of "dealers" and "brokers." It is irrelevant, however, in the context of regulation of investment "advisers," who by definition do not buy and sell securities for their customers, Investment Advisers Act of 1940, § 202(a)(11), 15 U. S. C. § 80b-2(a)(11), and thus are not normally in a position to obtain money directly by wrongful means. This change not reflecting any material alteration otherwise in the scope of the statute, Invest- [fol. 113] ment Advisers Act of 1940, § 206(1) and (2), 15 U. S. C. § 80b-6(1, 2), should be given the same broad construction, *mutatis mutandis*, as its predecessor. 3 Loss, Securities Regulation 1515 (2d Ed. 1961).[4] And of course it is the recognition that if investment advisers are to "defraud" anyone it will not be in the normal buyer-seller context which is crucial to this case. For it is in the secondary effects of advice, not in direct dealings, that the real potentials for fraud lie in this field. To reach and prevent that is the purpose of this legislation; defrauding in direct dealings is covered by the earlier Acts regulating brokers and dealers.

The majority, verbally emphasizing that the Act should be construed to achieve its remedial ends, recognize that manipulation, if intentional, would come within the scope of the Act. Certainly such activity—whatever it may be held to mean—would not be covered if the statute were narrowly limited. Compare Securities Exchange Act of 1934, § 10(b), 15 U. S. C. § 78j(b). Having recognized that purposeful manipulation would violate the Act, the

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[4] It seems a curious inversion of all principles of statutory construction to hold that the omission here of this unnecessary provision is proof of a legislative intent to limit the new Act strictly to the omitted prohibition. This topsy-turvy argument was made and rejected in *Seipel* v. *S.E.C.*, D. C. Cir., 229 F. 2d 758. See 3 Loss, Securities Regulation 1516 (2d Ed. 1961). *Seipel* held that the S.E.C. need not show all elements of common-law fraud to prove a violation of § 206 of the Investment Advisers Act.

opinion then states that there has been insufficient proof here of such activity to warrant granting an injunction. It is utterly unclear to me what further proof is needed. For what could be clearer from the facts as set forth by the SEC than that Capital Gains knew that its recommendations would affect the market and timed their issuance so it would profit therefrom? Cf. *S.E.C.* v. *Torr*, *supra*, D. C. S. D. N. Y., 22 F. Supp. 602, 608. "Intent," [fol. 114] if it need be found, can certainly be inferred from the facts as stated.

The majority's construction, however, is much narrower, for the gist of the opinion is that even intentional, secret manipulation is lawful if it is not "artificial." Thus it seems that an adviser can escape liability for scalping unless the SEC affirmatively proves he disbelieved his own recommendations. Since there are many creditable stocks upon which a plausible analysis can be built, such a burden will be almost impossible for the Commission to meet.

Not only is this construction inconsistent with the Congressional intent to regulate the effect of advisers on the markets and on unsuspecting customers and with the settled trend of interpretation of parallel antifraud provisions; it also conflicts with the holding of one of the chief cases on which the majority itself relies, *S.E.C.* v. *Torr*, D. C. S. D. N. Y., 15 F. Supp. 315, 317, reversed on other grounds 2 Cir., 87 F. 2d 446, reaffirmed on remand D. C. S. D. N. Y., 22 F. Supp. 602.[5]

Capital Gains violated its duty to disclose its secret trading. In a case brought prior to the passage of the 1940 statute the D. C. Circuit held that an investment adviser is in a fiduciary relationship with his clients and violates the antifraud sections of the 1933 and 1934 Acts by failing to reveal that he simultaneously exercised the role of broker-dealer, thus gaining a material interest in their

[5] In reversing the grant of a preliminary injunction, this court did not question the existence of a statutory violation, but held that, since the defendants had ceased engaging in the questioned practices and gave no indication of resuming them, the injunction was improvidently granted. On remand, Judge Woolsey reaffirmed the holding that the defendants' conduct violated § 17 (a) of the Securities Act of 1933, 15 U. S. C. § 77q(a).

response to his advice. *Hughes* v. *S.E.C., supra,* D. C. Cir., 174 F. 2d 969. And in *Charles Hughes & Co.* v. *S.E.C., supra,* 2 Cir., 139 F. 2d 434, 437, certiorari denied 321 U. S. 786, we held that a registered broker-dealer which [fol. 115] had secured the confidence of its customers in the reliability of its recommendations committed statutory fraud by withholding the fact that the price charged its customers was above the prevailing market. "Once that confidence was established, the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device."

Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally installed in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

Thus the majority's approving citation of *S. E. C.* v. *Torr, supra,* D. C. S. D. N. Y., 15 F. Supp. 315, is strange. For the finding of a statutory violation there is equally applicable in this case. In *Torr,* defendants were paid a bonus for all activity in a particular stock on the New York Curb Exchange which could be fairly attributed to the effects of their influence in touting the security. The court held that they committed statutory fraud when, in honestly recommending a perfectly good security, they suppressed the fact that they had such a direct financial interest in inducing clients to rely on their advice. The economic situation in this case is precisely the same.

[fol. 116] Some of my brothers seemingly draw some comfort in believing that the destructive effect of this construction of the statute will be limited in effect and duration because of powers now granted to the SEC by the

1960 amendment to the statute, § 206(4), 15 U. S. C. § 80b-6(4). That amendment adds another prohibition which makes it unlawful for advisers to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and authorizes the SEC to issue rules and regulations defining and prescribing means to prevent such behavior. The thought seems to be that the SEC will hereafter outlaw the defendants' activities by regulation. This suggests an easy solution to a problem which is obviously bemusing the court. But like many an "easy" solution it becomes in reality the harder one because of the difficulties it creates. Among those difficulties are those of time, of power and validity of the indicated action, of legislative policy in the premises, and of potential paralysis of agency action and the execution of Congressional policies.

On the matter of time it is obvious that under the most favorable conditions—that even if it be eventually adjudicated that the SEC can declare activities criminal which the court now holds perfectly legal—it will be several years before any regulation hitting the defendants' practices can be properly drafted, enacted, and then upheld judicially. Obviously not in our generation can any effective regulation along this line be expected. As counsel pointed out in argument, the mere drafting is a matter requiring time and unusual skill, even before the product is submitted to public scrutiny through official hearings and other means. In the two regulations it has adopted under this new statute the SEC has wisely limited itself to means and devices to effectuate what it accepts as the declared policy of the statute and is not making new policy. One of these, SEC release No. 120, Oct. 16, 1961, requires registration of stock dealings by advisers *and* [fol. 117] *their staffs*, thus giving it information as to the persons actually engaged in the investment counseling; while the other, SEC Release No. 121, Nov. 2, 1961, deals with *advertising* by investment advisers and is aimed to prevent advertising contrary to the statutory intent, i.e., fraudulent, deceptive, or manipulative. Neither of these would reach defendants' practices here; to do so would require a change in SEC policy, not merely to implement

Congressional bans, but itself to initiate and define a ban and make it operative.

And that leads to the difficult problem of validity of such a prohibition. In *Greene v. Dietz, supra*, 2 Cir., 247 F. 2d 689, we were troubled by the power of the SEC to make regulations not authorized by Congress or possibly contrary to the Congressional mandate. That question, which we did not try to resolve definitively, would arise in acute form here in view of the decision that scalping is a permitted and uncriticizable practice under present legislation. This, as I have indicated, means in substance that only common-law fraud, i.e., misrepresentation relied on to one's loss, is interdicted by the provisions of § 206(1) and (2).[6] What is changed under the new amendment? Obviously the words "fraudulent" and "deceptive" add nothing more; the only addition is the word "manipulative." But it is difficult to perceive how a court which does not regard scalping as fraudulent can conceive of it as [fol. 118] manipulative; it must believe that the practice amounts only to ordinary buying and selling in the natural course of business. There thus would be serious question as to the validity of a regulation prohibiting and making criminal practices not prohibited by Congress—a question needless to say which does not arise under what seems to me the more natural interpretation of the Congressional purpose which I urge.

The other two objections I shall discuss together more hurriedly. In both the original and the amended additional form of the statute, the prohibition (whatever its mean-

[6] The panel opinion by Judge Moore, 2 Cir., 300 F. 2d 745, has been adversely cited by commentators as indicating, *contra* to settled and uniform authority, that the antifraud provisions of the Securities Acts are limited to the narrow elements of common-law fraud. This is the position taken by Professor Loss in the 1962 Supplement to his treatise, 3 Loss, Securities Regulation 1435 n. 19 (1962 Supp.), and by Note, 75 Harv. L. Rev. 1449, 1450 n. 6 (1962). See also Note, 71 Yale L. J. 1342, 1347 (1962). While the majority opinion here is more guarded as to rationale and more generous in disclaiming illiberality than its predecessor, the effect of the opinion is precisely the same. Moreover, no attempt is made to distinguish the language of § 206 from identical phrases in the other antifraud statutes and rules.

ing) is made direct and unequivocal: "it *shall be unlawful* for any investment adviser" subject to the Act to engage in the fraudulent, deceptive, or manipulative act, practice, or course of business. The mandate is not made subject to the condition precedent of some validating action by the SEC; it cannot add to or subtract from the Congressional action. When Congress wished to provide such a condition precedent it knew how to do it. Thus in § 10(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j (a), it made unlawful the use of means to effect a short sale "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." And in subdivision (b) it enacted a like provision as to manipulative or deceptive devices or contrivances in connection with the purchase and sale of any securities. The addition by way of gloss here of such a condition precedent suggests a general rule (there being no special reason for limiting it to the present case) which would go well beyond this case in destructive possibilities. Now in general the regulatory agencies seek injunctions to effectuate legislative policy;[7] if first there [fol. 119] must be some definite and precise agency regulation the execution of Congressional policy will be hampered and delayed, if not made impossible.

In short, the hope of a regulation which will require Capital Gains to meet appropriate fiduciary standards

[7] All of the six securities acts contain provisions authorizing injunctive relief without conditions, such as are here being formulated. See, e.g., Securities Act of 1933, § 20, 15 U. S. C. § 77t; Securities Exchange Act of 1934, § 27, 15 U. S. C. § 78aa; Investment Advisers Act of 1940, § 209, 15 U. S. C. § 80b-9. Many, perhaps most, other statutes administered by government agencies authorize injunctive relief. See, e.g., Agricultural Adjustment Act, § 8a(6), 7 U. S. C. § 608a(6); Civil Aeronautics Act of 1938, § 1007, 49 U. S. C. § 647; Communications Act of 1934, § 401, 47 U. S. C. § 401; Federal Trade Commission Act, § 13, 15 U. S. C. § 53; Interstate Commerce Act, § 16(12), 49 U. S. C. § 16(12); Labor Management Relations Act of 1947, § 101(*l*), 29 U. S. C. § 160 (*l*). Arguments against a required rule-making in this connection are stated in 75 Harv. L. Rev. 1449, 1451 (1962), discussing *Cady, Roberts & Co.*, SEC Release No. 6668, Nov. 8, 1961.

not contained in the statute is illusory indeed. I see no ameliorating factor to lessen the harshness of the decision, and am completely at a loss to understand the reason for it. As I have indicated, it is not a required result; actually the contrary would have been much simpler under the precedents, particularly because of the troublesome doubt now cast upon the meaning of the antifraud provisions of the Securities and Securities Exchange Acts. Perhaps its worst feature is that it sanctions and indeed endorses a low standard of business morality, as the business world has apparently been quick to see.[8] The form of scalping here engaged in is a shocking business, as well as the chief method by which an investment adviser may bilk his clients. This regulatory statute was explicitly aimed to protect the loyal investment adviser against the tipsters and touts and the less desirable members of the profession generally. In all probability it will be those devoted [fol. 120] fiduciaries who will be hardest hit by this decision which levels all to one low standard. By holding scalping not a violation of § 206(1) and (2), the majority not only have sadly emasculated a promising statute, but have also cast doubt generally upon all governmental regulation in the general public interest.

I therefore reiterate the position I took in dissenting initially from the decision of the panel majority, 2 Cir., 300 F. 2d 751, 754. I believe the decision below should be reversed, and an injunction *pendente lite* granted.

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[8] See the syndicated columns of the financial writer Sylvia Porter in the New York Post for Jan. 4, 1962, "Stock 'Scalping' Upheld by Court"; Jan. 5, 1962, "Investment and Ethics"; and Feb. 16, 1962, "Stock 'Scalping' Faces Court Test." Cf. Leslie Gould, Financial Editor, "SEC Puts Postscript on 'You Only Have to Get Rich Once' Book," N. Y. Journal-American, May 24, 1962, p. 29.

[fol. 121]

IN UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

* * * *

Present: HON. J. EDWARD LUMBARD, Chief Judge,
HON. CHARLES E. CLARK,
HON. STERRY R. WATERMAN,
HON. LEONARD P. MOORE,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,
HON. THURGOOD MARSHALL,
Circuit Judges.

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLANT

v.

CAPITAL GAINS RESEARCH BUREAU, INC., and
HARRY P. SCHWARZMANN, DEFENDANTS-APPELLEES

JUDGMENT—July 13, 1962

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

[fol. 122] [File Endorsement Omitted]

[fol. 123] Clerk's Certificate to foregoing transcript omitted in printing

[fol. 124]

SUPREME COURT OF THE UNITED STATES

No. ...., *October Term, 1962*

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

vs

CAPITAL GAINS RESEARCH BUREAU, INC.
and HARRY F. SCHWARZMAN

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—October 18, 1962

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including

November 10, 1962

/s/ John M. Harlan
Associate Justice of the Supreme Court of the United States.

Dated this 18th
day of October, 1962

[fol. 125]

SUPREME COURT OF THE UNITED STATES

No. ...., *October Term, 1962*

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

vs

CAPITAL GAINS RESEARCH BUREAU, INC.
and HARRY F. SCHWARZMANN

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—November 6, 1962

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, further extended to and including

November 26th, 1962.

/s/ John M. Harlan
Associate Justice of the Supreme Court of the United States.

Dated this 6th
day of November, 1962.

[fol. 126]

SUPREME COURT OF THE UNITED STATES

No. 618, October Term, 1962

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

vs

CAPITAL GAINS RESEARCH BUREAU, INC., ET AL.

ORDER ALLOWING CERTIORARI—January 21, 1963.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1963 677840 961

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No.——

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CAPITAL GAINS RESEARCH BUREAU, INC., AND HARRY P. SCHWARZMANN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit *en banc*, entered on July 13, 1962, which affirmed by a 5-4 vote the order entered on March 1, 1961, by the United States District Court for the Southern District of New York.

OPINIONS BELOW

The opinion of the district court (R. 38-40)[1] is reported at 191 F. Supp. 897. The opinions of a panel

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[1] Citation is to the Appendix to the Brief of the Securities and Exchange Commission in the court of appeals which is Volumn I of the two-volume record certified by the Clerk of the Court of Appeals for the Second Circuit. Nine additional copies of this Appendix are being filed herewith.

of the court of appeals (App. A, *infra*, pp. 1a–12a; 12a–17a) are reported at 300 F. 2d 745. The opinions of the court of appeals upon rehearing *en banc* (App. A, *infra*, pp. 18a–27a; 27a–45a) are not yet reported.

JURISDICTION

The judgment of the court of appeals *en banc* was entered on July 13, 1962 (App. B, *infra*, p. 46a). The time to file a petition for a writ of certiorari has been extended to November 26, 1962, upon timely applications for extensions granted by orders of Mr. Justice Harlan entered October 18, and November 6, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the practice commonly known in the investment business as "scalping"—the purchase by an investment adviser of a stock just prior to his widespread recommendation of the stock to his clients, followed by the sale of the stock at a profit upon the rise in the market price which customarily follows such recommendations, without disclosure of his personal interest—is a "device, scheme, or artifice to defraud," or a "practice * * * which operates as a fraud or deceit" upon the investment adviser's clients in violation of Section 206 (1) and (2) of the Investment Advisers Act of 1940.

STATUTES INVOLVED

Prior to its amendment in 1960 (see, *infra*, p. 18), Section 206 of the Investment Advisers Act of 1940,

54 Stat. 847, 15 U.S.C. (1958 ed.) 80b-6 provided in pertinent part:

> It shall be unlawful for any investment adviser * * *, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * * * *

Other relevant statutory provisions are set forth in Appendix C, *infra*, pp. 47a–49a.

STATEMENT

The respondent Capital Gains Research Bureau, Inc., is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers' Act of 1940. The company is operated by respondent Harry P. Schwarzmann, its president and principal stockholder (R. 9). The principal business of Capital Gains is the publication of two investment advisory services. The one involved in this case is called "A Capital Gains Report," and is described as "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued" (R. 30). The service consists of a monthly bulletin (see R. 47) in which respondents evaluate and recommend the pur-

chase of a single specific security (R. 30-32). In so doing respondents may evaluate and report adversely on securities of comparable enterprises. The Report is issued to approximately 5,000 subscribers, who pay $18.00 per year for the service, and is frequently distributed without charge to as many as 100,000 non-subscribers whose names appear on mailing lists (R. 9, 10).

During the period from March 15, 1960, through November 7, 1960, respondents on six different occasions purchased a particular security and shortly issued a Capital Gains Report recommending the security for long-term investment. In each instance, the market price rose within a few days after distribution of respondents' bulletin. Respondents then sold the shares at a profit. In one instance respondents profited not only from the purchase, recommendation and sale of a security (Frank G. Shattuck Co.), but also from selling short a security which they then stated was overpriced (Chock Full O'Nuts). Prior to the issuance of this bulletin, they had purchased three-month calls on the Shattuck stock and had sold short stock of Chock Full O'Nuts. After publication of the bulletin, when the price of the Shattuck stock had risen and that of the Chock Full O'Nuts stock had declined, respondents exercised their call options on the former and covered their short sales of the latter, in each instance at a profit.

The timing and profits of respondents' purchases, recommendations and sales of the seven securities may be summarized as follows (R. 9–25):

Stock	Purchased	Recommended	Sold	Profit
Continental Insurance Co.	3/15/60	3/18/60	3/29/60	[1] $1,125.00
United Fruit Co.	5/13, 16, 19, 20/60	5/27/60	6/6, 7, 9, 10/60	$10,725.00
Creole Petroleum Corp.	7/5, 14/60	7/15/60	7/20, 21, 22/60	[1] $1,762.50
Hart, Schaffner & Marx.	8/8/60	8/12/60	8/18, 22/60	$837.00
Union Pacific	10/28, 31/60	11/1/60	11/7/60	$1,757.00
Frank G. Shattuck Co.	10/11/60 (purchased calls).	10/14/60	10/25/60 (exercised calls)	$695.17
Chock Full O' Nuts	10/4/60 (sold short)	10/14/60 (disparaged)	10/24/60 (covered)	$2,772.33

[1] Since the exact prices at which these transactions occurred are not given, this figure represents the minimum profit as computed upon the highest possible market purchase price and the lowest possible market selling price on the days in question.

Respondents did not disclose any aspect of any of the foregoing transactions to their clients (R. 14).

In November 1960, the Commission commenced an action in the district court alleging that respondents had "employed devices, schemes and artifices to defraud clients * * * and prospective clients" and "engaged in transactions, practices and courses of business which operate and have operated as a fraud and deceit" upon such clients in violation of Section 206 (1) and (2) of the Investment Advisers Act (R. 1–4). The Commission sought an injunction to require respondents to disclose the material facts concerning their practices as part of any future bulletin (R. 3–4). The district court denied a preliminary injunction, holding that the foregoing facts did not establish a violation of the statute.[2] On ap-

[2] The district court determined that the words "fraud" and "deceit" were used in Section 206 in a "technical sense" and

peal, a panel of the court of appeals, one judge dissenting, affirmed (App. A, *infra*, pp. 1a–12a; 12–17a). Subsequently, the court *en banc* reaffirmed the district court's order in a 5–4 decision.[3]

While recognizing (App. A, *infra*, p. 21a) that the "federal securities laws are to be construed broadly to effectuate their remedial purpose" and that "a relationship of trust and confidence should exist between the advisor and the advised," the majority held that respondents had not violated their fiduciary duty to their clients by failing to disclose their holdings of the stocks recommended and their practice of selling those securities shortly after their recommendations, and thus profiting "personally from the predictable market effect of [their] honest advice." The court held that the statute requires the Commission to prove that the individual security recommendations were made in bad faith, and the court refused to infer bad faith from respondents' practice. The majority indicated that if, at the trial, the Commission were able to establish that the respondent firm made its recommendations "for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such

required proof either that respondents intended that their clients lose money or that the clients had in fact suffered losses as a result of respondents' advice (R. 39).

[3] The opinion of the court *en banc* (App. A., infra, pp 18a–27a) was written by Judge Moore and joined in by Chief Judge Lumbard and Judges Waterman, Friendly and Hays; the dissenting opinion (App. A, *infra*, pp. 27a–45a), written by Judge Clark, was joined in by Judges Smith, Kaufman and Marshall.

conduct might well find itself within the prohibitions of Section 206 (1) and (2)". (*ibid.*).

The four dissenters criticized the majority's "uniquely strict interpretation" of the Investment Advisers Act of 1940, "the last of the six great regulatory statutes governing dealings in investments" (App. A, *infra*, p. 27a). They stated (App. A, *infra*, p. 40a):

> Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally installed in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

REASONS FOR GRANTING THE WRIT

This case, the first to come before the Court under the Investment Advisers Act of 1940, presents a question of statutory interpretation important in protecting the public against fraud. Section 206 (1) and (2) of the Act makes it unlawful for an investment

adviser "to employ any device, scheme, or artifice to defraud," or "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon," any actual or prospective client. The question is whether an investment adviser violates these provisions by engaging in the practice known as "scalping," *i.e.,* trading on the predictable market effect of his investment advice, for example, as here, purchasing securities immediately prior to recommending them to his clients and then selling at the profit made possible by the predictable market rise resulting from his recommendation, all without disclosure to the clients.

As the dissenting opinion below pointed out, the Investment Advisers Act "was designed to protect 'the public' 'from the frauds and misrepresentations of unscrupulous tipsters and touts' and to safeguard bona fide investment counsel 'against the stigma of the activities of these individuals.'"[4] The decision of the majority, by sanctioning the practice of scalping, seriously weakens the effectiveness of the Act in protecting the investing public against such unscrupulous activities. As the dissent noted, it "sanctions and indeed endorses a low standard of business morality" (App. A, *infra,* pp. 36a, 45a). It would also have an inhibiting effect upon the interpretation and enforcement of the antifraud provisions of other federal securities statutes[5] which are cast in the same

[4] App. A, *infra,* p. 36a. The dissent is quoting from S. Rep. No. 1775, 76th Cong., 3d Sess., p. 21.

[5] See, *e.g.,* Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a).

terms and which have never been construed by this Court.[6] The importance of this decision to the future administration of the federal securities laws is particularly serious since the Second Circuit encompasses the nation's largest financial community and the center of the country's securities industry.[7]

1. The majority opinion sanctions a breach of the fiduciary duty which an investment adviser owes to his clients. This duty requires disinterested advice and disclosure of all material facts which the client may need to evaluate the advice. (See cases cited and discussed, *infra*, pp. 11–15). Section 206 (1) and (2) of the Investment Advisers Act incorporates this standard of conduct as part of its proscription of fraud and deceit.[8] In holding that this duty of disinterested ad-

[6] In disregarding earlier opinions construing these securities laws, which are in *pari materia* with the Investment Advisers Act, the decision below creates a conflict in principle with decisions of courts of appeals of other circuits, as well as of the court below, as to the breadth of the general anti-fraud provisions of these securities laws.

[7] Although the decision below determined the propriety of the district court's denial of a preliminary injunction, it rests not on the state of the record but upon the majority's interpretation of the substantive scope of Section 206 (1) and (2) of the Investment Advisers Act. These circumstances are sufficient to warrant review of the interpretation of the statute without awaiting an order disposing of the entire case. Cf. *Hanover Star Milling Co.* v. *Metcalf*, 240 U.S. 403, 408–409. The preliminary injunction is often the only effective weapon against infractions of the securities laws. By the time a permanent injunction can be obtained, the damage may be irreparable.

[8] The Commission's 1939 Report to the Congress, from which the Act stemmed, makes it clear that the Investment Advisers

vice and full disclosure is violated only if the Commission can prove that the investment advice was given in bad faith, the majority below disregarded this fiduciary relationship, the history and purpose of the securities laws, and the cases which have interpreted those laws.

It is a basic requirement of securities regulation that once a relationship of trust and confidence—a fiduciary relationship—exists, the fiduciary comes under a duty not to use that relationship secretly for personal profit. This is particularly so where, as here, a conflict between the financial interests of the fiduciary and his beneficiaries is created. In the present case, the existence of this fiduciary relationship is conceded in the majority opinion, as is the fact that the Commission's evidence "tends * * * to show" that respondents "profited personally from the predictable market effect of [their] honest advice" (App. A, *infra*, p. 21a). That respondents failed to disclose their practice of using their advice for personal profit is undenied. The conflict of interest in this situation is apparent, for the adviser's selection of securities

Act was passed to require advisers to eliminate conflicts of interest with their clients:

"Broadly stated, the representatives [of the investment counseling industry] felt that investment counsel organizations could not completely perform their basic function—furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed."

Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission—Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H. Doc. No. 477, 76th Cong., 2d Sess. p. 28.

to recommend or disparage may well be influenced—intentionally or unintentionally—by their relative adaptability to profitable "scalping." The fact that the opinions expressed are "honest" when given (*i.e.*, that the adviser believed the securities to be a desirable long-term investment)—or at least cannot later be shown to have been dishonest—in no way removes the conflict of interest or the duty of disclosure.

The holding of the majority below, that a fiduciary's failure to make a full disclosure of his personal interest is permissible as long as his advice is otherwise honest, is a departure from the high standard of fiduciary conduct which the courts have recognized as required by similar antifraud provisions of the other federal securities laws. Thus, in *Securities and Exchange Commission* v. *Torr*, 15 F. Supp. 315 (S.D.N.Y.), reversed on other grounds, 87 F. 2d 446 (C.A. 2), reaffirmed on remand, 22 F. Supp. 602, the district court held that the failure of securities dealers recommending a stock "solely on its merits" to disclose their financial interest in inducing clients to rely on their advice, violated Section 17(a) of the Securities Act of 1933 (15 U.S.C. 77q(a)), a general anti-fraud provision comparable to Section 206 (1) and (2) of the Investment Advisers Act. The main defendants in *Torr* held options on a large block of shares at a stated price. They stood to realize a substantial personal profit upon a rise in the price of a stock, and for this, "it was essential that there be an increased demand for the stock" (15 F. Supp. at 316). To stimulate the necessary demand, these defendants hired others to recommend the stock

to their acquaintances and the public generally. The recommendations were made without disclosure of these financial interests. In upholding the Commission's allegations of fraud, the court stated (15 F. Supp. at 317):

> * * * When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived. United States v. Brown, 79 F. (2d) 321 (C.C.A. 2). * * * In both cases there is an "omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

The Court so held notwithstanding its assumption that the stock was recommended "on its merits" (*id.* at 316, 317).

The Court of Appeals for the District of Columbia Circuit reached the same conclusion in *Hughes* v. *Securities and Exchange Commission*, 174 F. 2d 969. It held that an investment adviser is in a fiduciary relationship with his clients and commits a fraud or deceit by failing to reveal that he simultaneously exercises the role of dealer, thus standing to benefit from their response to his advice.[9] The fact that

[9] The court interpreted the antifraud provisions of the statute to require full disclosure of all relevant data which may be necessary for an intelligent response to securities advice. It stated (174 F. 2d at 976):

"* * * It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge

the clients fully understood this dual relationship and that they had been afforded "a high degree of investment protection, financial gain and security and financial peace of mind, * * *" (*id.* at 974), provided no defense.

There is, if anything, an even clearer fiduciary duty here. The defendants in *Torr* were found to have violated the anti-fraud provisions of the securities laws by giving honest investment advice free of charge without revealing their financial interest in the response to that advice. Here, 5,000 subscribers to respondents' "Capital Gains Report" purchased purportedly disinterested advice at a cost of $18 per year. The resulting fiduciary relationship entitles these clients to respondents' unbiased judgment as to the merits of particular securities. Just as in *Torr,* where the court accepted the defendants' insistence that they "recommended the stock solely on its merits" (15 F. Supp. at 317), the respondents in the present case did not fulfill their fiduciary duty merely by giving "honest advice." Their advice had to be "disinterested" as well, and it was not disinterested when they were relying upon its "predictable market effect" as a basis for personal profit (App. A, *infra,* p. 21a). Their failure to satisfy their fiduciary duty to their clients by disclosing all of these facts constituted a "device, scheme, or artifice to defraud," and a "practice, or course of business which operates as a

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material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure."

fraud or deceit" upon their clients within the meaning of Section 206 (1) and (2).

The majority's decision is inconsistent with the majority's own recognition that "federal securities laws are to be construed broadly to effectuate their remedial purpose" (App. A, *infra*, p. 21a; *Securities and Exchange Commission* v. *Joiner Corp.*, 320 U.S. 344, 353–354)—a principle which many other courts have also recognized in construing comparable anti-fraud provisions of the Securities Act of 1933 (Section 17a, 15 U.S.C. 77q(a)), the Securities Exchange Act of 1934 (Section 10(b), 15 U.S.C. 78j(b)) and of Rule 10b-5(3) issued pursuant to the Securities Exchange Act.[10] See *Charles Hughes & Co.* v. *Securities and Exchange Commission,* 139 F. 2d 434 (C.A. 2), certiorari denied, 321 U.S. 786; *Archer* v. *Securities and Exchange Commission,* 133 F. 2d 795 (C.A. 8), certiorari denied, 319 U.S. 767. See also *Speed* v. *Transamerica Corporation,* 235 F. 2d 369, 373 (C.A. 3).

Apparently, this lowering of standards results from a misreading of this Court's decision in *Blau* v. *Leh-*

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[10] Like Section 206(1) of the Investment Advisers Act, Section 17(a)(1) of the Securities Act and Rule 10b–5(1) under the Securities Exchange Act utilize the language "to employ any device, scheme, or artifice to defraud." Like Section 206(2) of the Investment Advisers Act, Section 17(a)(3) of the Securities Act contains the language "to engage in any transaction, practice, or course of business which operates [or would operate] as a fraud or deceit." Identical language is contained in Rule 10b–5(3) under the Securities Exchange Act except that the word "act" is substituted for the word "transaction." This language of Rule 10b–5(3) is also contained in Rule 15c1–2(a) under Section 15(c)(1) of the Securities Exchange Act.

man, 368 U.S. 403 (involving the Securities Exchange Act of 1934). The court below relied heavily upon that opinion as presaging a more restrictive interpretation of the securities laws (App. A, *infra,* p. 22a). Only this Court can correct the result.

2. The court below erroneously relied upon the legislative history of the 1960 amendments to the Investment Advisers Act[11] as support for its narrow construction of Section 206 (App. A, *infra,* pp. 22a–27a). This history consists of statements and memoranda of Commission representatives submitted in support of the amendments as well as various congressional committee reports which draw conclusions from these materials. As the dissent below points out, these sources do not support a "narrow interpretation of § 206"; moreover, the majority's "extensive discussion is not of history, but of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act" and "reliance on them violates canons of construction laid down by the Supreme Court" (App. A, *infra,* pp. 34a, 35a). See *Rainwater* v. *United States,* 356 U.S. 590, 593.

More specifically, neither these 1959–1960 legislative materials nor the doubts expressed by the Commission concerning the reach of the statute and the need for rulemaking powers were addressed to the

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[11] *Independent Regulatory Commissions,* Report of the Special Subcommittee on Legislative Oversight of the Senate Committee on Interstate and Foreign Commerce, H. Rep. No. 2711, 85th Cong., 2d Sess.; Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 1178, etc., 86th Cong., 1st Sess.; H. Rep. 2179, 86th Cong., 2d Sess.; S. Rep. No. 1760, 86th Cong., 2d Sess.

issue presented here—the legality of "scalping." Commission representatives testified before the House Subcommittee on Legislative Oversight of the Committee on Interstate and Foreign Commerce that the Act did not require an investment advisory service which recommended Crowell-Collier securities to disclose under the circumstances there present that a mutual fund of which it was adviser held stock in that concern. They pointed out, however, that in many cases failure to disclose an interest in a security might involve a fraud upon a client within the meaning of Section 206 of the Act.[12]

The Commission has never taken the position that the antifraud provisions do not reach the scalping practices here involved, which go far beyond the recommendation of a security in which the adviser has an interest, since here the adviser made a practice of reaping a personal profit from trading in the securities which he recommended. The views expressed by the Commission in connection with the 1960 legislation concerned the need for rule-making powers to proscribe non-fraudulent practices which, in the Commission's judgment, lead to fraud. Since scalping meets the standard of fraud which the courts have applied in construing federal securities laws, its illegality is unaffected by these views.

That the Commission has always so believed is borne out by its enforcement action. In 1946, the Commission acted under Section 206(2) in proceeding against scalping practices indistinguishable from

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[12] *Investigation of Regulatory Commissions and Agencies*, 85th Cong., 2d Sess., Part 12 (Hearings of September 17, 1958), pp. 4838–4840.

those permitted by the court below. See *Securities and Exchange Commission* v. *Frank Payson Todd*, Civil No. 6149 (D. Mass.).[18] Cf. *Seipel* v. *Securities and Exchange Commission*, 229 F. 2d 758 (C.A.D.C.).

3. The 1960 amendment to Section 206 of the Investment Advisers Act, on which the majority below relied (App. A, *infra*, pp. 22a–23a), neither supports the decision nor militates against the need for review by this Court. As Judge Clark pointed out for the dissenters, the holding of the majority is "based on a seriously limiting interpretation of the antifraud provisions of the Act" (App. A, *infra*, p. 32a), and if allowed to stand, is likely to have serious re-

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[18] In that case, the defendant admitted the allegations of the complaint and consented to the entry of an injunction. Securities and Exchange Commission Litigation Release No. 372, November 14, 1946, describes the defendant's activities as follows:

"The complaint alleged that Todd defrauded investment advisory clients in the following manner: Todd issues a weekly letter, 'The New England Counsellor,' in which he advises subscribers with respect to the purchase of securities. He also has certain clients who for an additional fee obtain more personalized advice, and until recently he managed a number of discretionary accounts. Todd would withhold making his recommendation to purchase specific securities for several days, during which he would purchase the security for his discretionary accounts and orally recommend its purchase to clients receiving more personalized advice. It would usually be an inactive security and, when the market had been raised by the subscribers' purchases, Todd would sell the security in his discretionary accounts, meanwhile continuing to recommend its purchase in his weekly letter."

The Commission's complaint alleged that Todd "managed a discretionary account in the name of his wife, Mary K. Todd."

The injunction was later vacated on grounds not germane here. 3 Loss, *Securities Regulation* (2d ed. 1961) 1516.

percussions upon the protection of investors which the Act was designed to provide.[14]

The 1960 amendments (74 Stat. 885, 887) added Subsection (4) to Section 206 of the Investment Advisers Act, which provides:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> * * * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

In determining the need for review in this case, it is immaterial whether or not the amendment permits the Commission to proscribe conduct which is neither

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[14] See Educational Circular No. 170 of the New York Stock Exchange, November 16, 1962, p. 4, discussed in the Wall Street Journal, November 19, 1962, p. 4, cols. 2, 3, as follows:

"In its circular the [Stock Exchange] warned member-firm personnel to refrain from trading in any security shortly before or after a recommendation to buy or sell that security had been issued by the firm. They are prohibited from buying and selling such recommended securities either for accounts in which they have an interest or accounts in which they have authority to use their own judgment in trading. They are also prohibited from 'passing on advance information concerning the report to persons outside their firm.'"

"fraudulent" nor "deceptive."[18] The language of Subsection (4) is not self-executing. The Commission has for many years interpreted comparable provisions of the Securities Exchange Act, Section 15(c)(2), 15 U.S.C. 78*o*(c)(2), as granting only rulemaking power and not themselves imposing any substantive requirements. It views Section 206(4) of the Investment Advisers Act as similarly requiring it to issue implementing rules and regulations before proceeding under that subsection.

Nor is the need for review vitiated by the majority's suggestion that its limiting interpretation of the antifraud provisions is of little consequence because the Commission now has authority to prohibit this conduct by rules and regulations. Concededly, Subsection (4) authorizes, and the Commission could draft, a rule which would proscribe, as a "means reasonably designed to prevent" fraud, the specific conduct described in the complaint initiating this action. However, the necessity of proceeding by rule would be a pale substitute for the "general and

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[18] There may be a question of the extent to which "manipulative" reaches activities which are not also "fraudulent" or "deceptive." See, for example, Section 15(c)(1) of the Securities Exchange Act which directs the Commission to adopt rules defining "such devices or contrivances as are manipulative, deceptive, or *otherwise* fraudulent" (emphasis supplied). And cf. *United States* v. *Brown*, 79 F. 2d 321, 325 (C.A. 2), where in a case under the mail fraud statute, 18 U.S.C. 338, Judge Learned Hand explained: "Wash sales [a common form of manipulation] are a deceit, because they broadcast the fact that a buyer and a seller have agreed to exchange the shares at the published price, when they have not done so." Manipulation involves activities conducted for the purpose of artificially influencing the market.

flexible" antifraud provisions which the courts have long recognized as necessary to keep in check "the versatile inventions of fraud-doers." [16] If the Commission is to prevent clever operators from keeping one step ahead of the enforcement officers, it should not be limited to proceeding by rules which attempt to catalogue in advance every species of fraud. The decision below, in suggesting that the Commission's authority is so limited, seriously impedes future enforcement of the securities laws.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

STEPHEN J. POLLAK,
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DAVID FERBER,
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WALTER P. NORTH,
Associate General Counsel,

MICHAEL JOSEPH,
Attorney,
Securities and Exchange Commission.

NOVEMBER 1962.

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[16] *Stonemets* v. *Head*, 248 Mo. 243, 154 S.W. 108, 114; and see *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795, 803 (C.A. 8), certiorari denied, 319 U.S. 767. And see *State* v. *Whiteaker*, 118 Ore. 656, 247 Pac. 1077, 1079.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 30—September Term, 1961

(Argued October 13, 1961, Decided December 18, 1961)

Docket No. 26942

SECURITIES AND EXCHANGE COMMISSION,
Appellant,

v.

CAPITAL GAINS RESEARCH BUREAU, INC.,
AND HARRY P. SCHWARZMANN,
Appellees.

Before:

CLARK, WATERMAN and MOORE,
Circuit Judges.

MOORE, *Circuit Judge:*

Plaintiff (appellant), Securities and Exchange Commission (SEC), in its complaint, alleging violations of Section 206 (1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C.A. 80b–6 (1) and (2), sought a temporary restraining order, preliminary injunction and final injunction against defendants (appellees), Capital Gains Research Bureau, Inc. and Harry P. Schwarzmann, to prevent them from employing "any device, scheme or artifice to defraud any client or prospective client" and from engaging

"in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." By order to show cause based upon the complaint and an affidavit of an SEC investigator, a temporary restraining order was granted and a hearing upon an application for a preliminary injunction was directed. No additional proof was offered by the SEC upon the hearing; Schwarzmann, as owner of Capital Gains and as a defendant, submitted an affidavit opposing the application. The District Court upon this proof denied the motion for a preliminary injunction and vacated the stay. The SEC appeals.

Injunctive relief before a trial on the merits should be granted most sparingly and only upon convincing proof that irreparable injury will be caused unless the courts stay the defendants' conduct. Furthermore, the courts generally will not grant a preliminary injunction when the effect thereof will be to give the applicant all the relief to which he would be entitled if successful upon the final injunction trial.[1]

Applying these principles to the facts, the conclusions are inescapable that the SEC did not meet the "convincing" proof standard and that a preliminary injunction for all practical purposes would have given to the SEC all that it could have received by final injunction after trial.

Section 206 declares that it is unlawful for any investment adviser (1) "to employ any device, scheme or

[1] *W. A. Mack, Inc.* v. *General Motors Corp.* (7th Cir. 1958), 260 F. 2d 886; *Foundry Services* v. *Beneflux Corp.* (2d Cir. 1953), 206 F. 2d 214, 216; *Selchow & Richter Co.* v. *Western Printing & Lithographing Co.* (7th Cir. 1940), 112 F. 2d 430, 431; *United States* v. *Adler's Creamery* (2d Cir. 1939), 107 F. 2d 987, cert. denied, 311 U.S. 657 (1940); *Gross* v. *Kennedy*, 183 F. Supp. 750, 757 (S.D.N.Y. 1960); *Carey* v. *General Electric Co.*, 165 F. Supp. 127 (S.D.N.Y. 1958); *Dressler* v. *Wilson*, 155 F. Supp. 373, 376 (D.D.C. 1957).

artifice to defraud any client or prospective client" or (2) "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Fraud is the keynote of these provisions and the burden placed upon the party alleging fraud is that it be established by "clear and convincing"[2] proof.

The only question presented upon appeal at this stage of the proceedings (namely, in advance of a trial upon the merits) is whether the facts were so clear and convincing that fraud and deceit were being practiced upon defendants' clients that the District Court abused its discretion in not granting a preliminary injunction and in preferring to await the development of all the facts upon a trial before decreeing drastic injunctive sanctions.

Capital Gains publishes an investment advisory service. It distributes two bulletins, one entitled "Facts on the Funds" (not involved in this proceeding), which informs subscribers as to changes in the portfolios of Mutual Funds and another headed "Special Recommendation" or "Special Bulletin" which gives financial facts and figures concerning the specific company made the subject of the analysis. Only certain bulletins involving the special situations are before the court.

The SEC did not present in support of its application for a preliminary injunction any of the reports upon which it relied as showing a failure to disclose material facts. However, this deficiency was remedied by defendants who attached the special bulletins to their answering affidavit. In substance, the bulletins

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[2] *United States* v. *Thompson* (10th Cir. 1960), 279 F. 2d 165, 167, wherein the court referred to "the spirit of the long accepted rule of law that one who asserts fraud has the burden of proving it by clear and convincing evidence." See also 9 Wigmore, Evidence § 2498 (3d ed. 1940).

contain figures showing the corporate earnings over a period of years of the companies therein analyzed, an outline of the nature and current status of the business, future prospects, earnings and price-to-earnings ratios, (in some cases) the number of Funds which own the stock, and usually a brief résumé of assets and profits.

All seven companies[3] analyzed are substantial companies in their respective fields and their stocks have been listed and traded on the New York Stock Exchange for many years. No charge is made by the SEC that any misstatements or false figures were contained in any of the bulletins; that the investment advice was unsound; that defendants were being bribed or paid to tout a stock contrary to their own beliefs; or that these bulletins were a scheme to get rid of worthless stock. The SEC premises its entire case upon the fact that shortly before the bulletins were mailed, defendants, consistent with their forthcoming recommendations, purchased shares of the stock and, in one instance where they suggested that the stock was too high, sold short. The SEC then points to the facts that there were small market rises in each of the stocks following publication and that defendants sold the stocks previously purchased (or covered as to the short sale) by them within a week or two thereafter. Thus, the SEC by its own fiat would create a law not enacted by Congress or a regulation not promulgated by the SEC to the effect that the failure to disclose to clients to whom purchase was recommended that they (defendants), too, had made purchases, constituted a scheme to defraud by failing to disclose a material fact. But what is

[3] Continental Insurance, Creole Petroleum, Union Pacific, Hart, Schaffner & Marx, United Fruit, Shattuck and Chock Full O'Nuts.

the "material fact"? The SEC does not and cannot argue that it consists of a belief that the stock was a "sell" instead of a "buy" because there is no proof of any such belief. Furthermore, the action of defendants was consistent with their recommendations and belies such an inference. Of the seven stocks involved, the purchases (or in one case the short sale) in most instances were made just three to seven days before the reports containing the recommendations were mailed to the clients. Thus it would appear that the purchases were the result of the forthcoming recommendations. Certainly without any supporting proof a conclusion would not be justified that the recommendations were made to enable defendants to unload their own recently acquired and comparatively small holdings.

Presumably the SEC relies upon the defendants' subsequent sales as implying a belief that the stock analyzed was not a good purchase to be held more than six months. But even a then present intention to sell shortly after publication will not support an inference that the recommendation to others to buy and hold for the capital gains period was fraudulent or deceptive. And if this be the material omission, what is the remedy? A mere statement in the bulletins that defendants also owned certain shares would accomplish nothing. Thousands of other persons owned shares of the same companies. A statement that defendants intended to sell within two weeks would not be accurate because their intention to buy, sell or hold could be determined only in the light of then unknown events. If the market were strong, they might wish to take a small profit on an "income" tax basis or hold for the six months capital gains period; if the market were weak they might wish to limit their losses by selling or holding for a longer period, hoping for a recovery. Surely, no one could

be so naive as to believe that a small advisory service with only 5,000 subscribers could by its own recommending influence cause such stocks as Union Pacific (22,000,000 shares outstanding), Continental Insurance (12,000,000 shares outstanding) and United Fruit (8,730,000 shares outstanding)[4] invariably and automatically to rise so that defendants could always sell their small holdings at a small profit. In the one instance, Hart, Schaffner & Marx, where the company had less than one million shares outstanding, the clients were told that purchases were recommended "around the \$23-\$24 level" (the then current price). Such advice would hardly be consistent with an inference that it was intended thereby to raise the market price by their own clients' buying power. Moreover, it is significant that the SEC introduced no proof that any client ever purchased any shares of the recommended securities. The SEC's conclusion that these particular 5,000 subscribers must have rushed in, thereby creating an artificial stimulant, is wholly speculative and is at variance with common sense. Consider realistically the buying power which comes from pension funds, investment trusts, university and hospital endowments, foundations, insurance companies and some 180,000,000 citizens with their millions available daily for investment. In the light of such a situation, the comparatively few shares out of 22,000,000 (Union Pacific) that Schwarzmann's clients might have ordered would have been as the proverbial grain of sand is to the beach. And flattering though it might be to Schwarzmann, would anyone believe that his recommendation would stem the tide of decline if some pessimistic world event were simultaneously announced, some Mutual Fund chose to sell or an estate had to be liquidated?

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[4] Approximate figures.

The SEC contends that present intent to sell a stock in the near future if it rises must be accepted as conclusive proof that the advice to buy was dishonest and fraudulent. However, do not the vast majority of those who buy hope to sell at some time at a profit? When the sale will take place can be determined only by considerations personal to each purchaser. His own financial needs, his trading policy, his habit of accepting small profits or his policy of buying for the so-called long pull will control his actions. Of necessity, every purchase and sale transaction involves diametrically opposed thoughts by two individuals concerning the same stock but this does not create fraud and deception so long as false facts and figures have not motivated their action.

The result reached by the District Court in no way weakens the praiseworthy role of the SEC in its vigilant protection of unwary investors. The SEC correctly argues that federal securities laws are to be construed broadly to effectuate their remedial purpose. Nor can there be any serious dispute that a relationship of trust and confidence should exist between the adviser and the advised. A good example of a violation of this principle is found in *SEC v. Torr*:[5]

> When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived.

Another illustrative situation is in *Ridgely v. Keene*, 134 App. Div. 647, 119 N.Y.S. 451 (1909), where an

[5] 15 F. Supp. 315, 317 (S.D.N.Y. 1936), rev'd on other grounds (2d Cir. 1937), 87 F. 2d 446.

investment adviser failed to disclose that he was being paid to tout a stock.

The SEC's exception to the District Court's comment that there is no proof that any client lost any money by reason of defendants' acts is also well taken. The test is not gain or loss. It is whether the recommendation was honest when made.

The many cases cited by appellant and appellees are not germane to a resolution of the problem here presented. For the most part, they deal with the purchase and sale of securities by or through brokers where inside or so-called confidential information was possessed by one party to the transaction which was not disclosed to the other. These situations are typified by the recent decision of the SEC in *"In the Matter of Cady, Roberts & Co.*—No. 8-3925" (Nov. 8, 1961) wherein a broker having received advance notice of a substantial reduction in a company's dividend sold large quantities of the stock to purchasers who had no knowledge of the dividend cut and who undoubtedly would not have purchased (at least at the then quoted price) had they known the facts.

Nor is the decision of the District Court in any way at variance with the salutary purpose of the Investment Company Act of 1940 or the Investment Advisers Act of 1940. This court said in *Charles Hughes & Co.* v. *SEC* (2 Cir. 1943), 139 F. 2d 434, "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do * * * " (Clark, C.J.). And so it is. However, each case must be judged upon its particular facts after a full and fair hearing and not upon unwarranted inferences.*

* See *Hughes* v. *Treat*, 22 S.E.C. 623 (1946), where the proceedings were dismissed on the facts; Litigation Release 372 on *SEC* v. *Todd*, cited in 3 Loss, Securities Regulation, 1516, n. 122 (2d ed. 1961), where although the defendant had orig-

In final analysis what the SEC would have the court do here is to create a law which Congress has never enacted or a regulation which the SEC has never promulgated which, in effect, would prohibit investment advisers or their employees from purchasing or selling any of the many stocks covered by their services. Any such drastic legislation or regulation should be enacted only after hearings upon which the need, if any, for any such remedial legislation can be explored and all interested parties given an opportunity to be heard. Any such regulation should come only as suggested by the Supreme Court in *Miner* v. *Atlass*, 363 U.S. 641, 650 (1960) with respect to procedural innovations "only after mature consideration of informed opinion from all relevant quarters, with all the opportunities for comprehensive and integrated treatment which such consideration affords."

The benefits to be derived by the investing public, which otherwise would have no adequate basis for forming an opinion, as a result of receiving advice honestly given based upon the analysis of financial experts, scarcely can be doubted. A senior financial statesman, Bernard Baruch, has said:

> What of the man or woman with modest savings who is simply looking for a fair return on his or her savings and who cannot give full time to a study of investments? My advice to such persons is to seek out some trusted investment counselor.[7]

Congress and the SEC have been watchful of the interests of the investor. In September, 1960, Sec-

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inally consented to an injunction, it was vacated without objection by the SEC in order to permit a trial on the merits and eventually the SEC agreed to a dismissal because the provable facts would not have supported an injunction.

[7] Baruch, My Own Story (1957).

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tion 80b-6 was amended and subparagraph (4) was added (74 Stat. 887, P.L. 86-750 § 9) giving to the SEC the power to "by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." As stated in Senate Report No. 1760, June 28, 1960 (the Senate bill was passed). "This provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients." Acting thereunder the SEC in August, 1961, published its revised proposal to adopt its first Rule (Rule 206(4)-1) which declared certain advertisements by investment advisers to be fraudulent, deceptive or manipulative within the meaning of Section 206(4) of the Act. The SEC invited comments and suggestions on the proposals and after careful consideration thereof adopted a Rule, effective January 1, 1962. The stated and obvious purpose of the future date was to give persons and companies affected thereby an adequate opportunity to know the prohibition before they were condemned for violating it. (See, SEC Release No. 121, Nov. 2, 1961.) The same charge of fraud and deception might have been made against previous advertisements because it is common knowledge that for decades the public press has carried advertisements of investment advisory or stock trading services that listed their profitable selections and minimized or omitted their less successful recommendations. Believing that such advertising is deceptive and misleading, the SEC directs its discontinuance. But believing equally in fair play, the SEC affords a reasonable opportunity for compliance rather than seeking an immediate injunction against the advertising now in effect.

It is most significant that there is no statute, rule or regulation against any investment advisory service owning any shares of any security recommended or against the purchase or sale of any such shares within a specific period of time before or after publication. Whether such a rule would be in the public interest is not for judicial legislation or adjudication. The SEC has been charged by Congress with the making of such rules. The SEC has evinced a wise policy of promulgating its rules only after a careful study of all the facts, the holding of hearings, the weighing of testimony from interested parties, and consideration of comments and suggestions. Hundreds of individuals and companies are engaged in the business of investment advisers. What is the impact, if any, on the market of the investment advice of any one bulletin? Of what influence, if any, is the number of subscribers (1,000 or 50,000)? What if one service recommends the sale of a certain stock simultaneously with the independent recommendation of another service to purchase the same stock?[a] Is fraud to be presumed; and, if so, by which service? Countless other questions suggest themselves with which, if there be any need for regulation or control, the SEC will have to cope. For the present and until the facts are fully developed, it seems appropriate that the courts in piecemeal fashion do not try to take over the regulatory function of the SEC and single out a rather small advisory service and hold it in advance of trial responsible for violation of a rule which has not yet been promulgated and as to which there is no certainty that it ever will be.

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[a] The daily press and financial journals in reporting upon changes in Mutual Funds portfolios frequently disclose that the business judgment of one Fund dictated the sale of a certain stock at approximately the same time that another Fund considers the same stock an advisable purchase.

The order denying a preliminary injunction is affirmed.

CLARK, *Circuit Judge* (dissenting).

It can be demonstrated, I believe, that my brothers here have given a uniquely restrictive interpretation to the Investment Advisers Act of 1940—the last of the six great regulatory statutes governing dealings in investments—contrary to the general judicial approach to these statutes. But before I discuss this troublesome ruling I think I should note the unfortunately wide scope of the decision and its public importance. For it endorses and in effect validates a distressingly low standard of business morality. Cutting through all the procedural steps and noting the denial of the very mild and nonpunitive remedy of an injunction only preventing future violations, I find it all too clear that the opinion here, re-emphasizing the opinion below, has found nothing objectionable, much less illegal, in an investment adviser—a business fiduciary according to the intent of the regulatory statute—making substantial profits by secretly playing the market contrary to his advice to customers. I suspect the license thus granted is one the top advisers—those who are trusted by the banks, the insurance companies, and the investors generally—not only do not desire, but find rather shocking, in the doubt thus cast upon the good faith and loyalty of all of their profession. For all are thus reduced, in the eyes of the law, to the standards of the lowest.

While the over-all trend of the decision is thus obvious, the opinion does not make the facts or the law sufficiently clear to clarify the central legal issue. Actually the facts are substantially not in dispute; and the issue is whether the prohibitions of the Act, particularly those which prohibit engaging in any

course of business "which operates as a fraud or deceit upon any client or prospective client," 15 U.S.C. § 80b-6(2), are limited strictly to common law fraud, as the district court held, or express a wider fiduciary obligation of full disclosure of conflicting ties and full loyalty to the client's interest. As to the facts the S.E.C.—with commendable expedition and zeal, considering all the ramifications of its far-ranging tasks and the difficulties of detection generally—uncovered a half-dozen cases of private stock dealings by defendant Capital Gains at the behest of its sole stockholder and owner, Schwarzmann. These the Commission quite properly accepted as a pattern of defendants' normal activities, sufficient upon which to base a prayer for a preventive remedy for the future. The pattern was that Capital Gains would privately buy some well known stock for its private account, that it would describe the stock favorably in its bulletin "Special Recommendation" or "Special Bulletin," distributed to its 5,000 subscribers and frequently quite widely to the public on a mailing list of about 100,000, and that then in a few days, perhaps a couple of weeks or less, when the market price of the stock had risen, it would sell out, pocketing the gain. Apparently it did not look for spectacular market swings, but nevertheless it was able to achieve fairly steady profits from this course of dealings. In one spectacular case it combined this scheme successfully with the short selling of a stock it then proceeded to decry in its report as overpriced.

Defendants did not deny these specific instances, but attempted to play them down, stressing particularly that their operations were too small to cause the market swings and that their clients did not lose because the stocks were good investments. Of course it is difficult to tell surely what will cause a good stock to go up a few points; but it seems likely that con-

centrated buying may have some effect, and it is significant that in each case the market did actually respond in the way desired. But this defense, which has been fully accepted by my brothers, completely misses the point. A first duty of a fiduciary is loyalty to his beneficiary; if he is engaged in feathering his own nest, he cannot be giving his client that wholly disinterested advice which it is his stock in trade to provide. My brothers appear to assume that the practices indulged in by the defendants here are quite widespread on the part of investment advisers. There is not a bit of evidence before us to this effect, and personally I do not believe it for a minute. But further it appears quite clear that it was the purpose of the legislation to outlaw and stop such practices.

The history of this legislation shows a Congressional intent to establish a fiduciary relationship on the part of the adviser to his client; it also shows a purpose to safeguard bona fide investment counsel against the stigma of the activities of unscrupulous tipsters and touts. This is convincingly traced by the leading academic authority in the field, 2 Loss, Securities Regulation 1392 *et seq.* (2d Ed. 1961). It is quite obvious that this broad and complete supervision of the adviser who was required by the Act to register would be quite frustrated if the Commission had to show at every step common law fraud, including intentional misrepresentation to a specific person to his individual loss. Actually there is convincing evidence to the contrary. As Professor Loss, after quoting the two subsections relied on by the Commission, § 206 (1) and (2); 15 U.S.C. § 80b–6 (1) and (2), points out: "These clauses are modeled on Clauses (1) and (3) of § 17(a) of the Securities Act [15 U.S.C. § 77q(a) (1) and (3)]. Consequently, everything which has been said thus far in this chapter applies with equal force to investment advisers *mutatis mutandis.*" 3

Loss, Securities Regulation 1515 (2d Ed. 1961). This carries his discussion back to his earlier detailed consideration of SEC "fraud" concepts going well beyond circumstances giving rise to a common law action of deceit. 3 Loss, Securities Regulation 1430, 1435, 1474 (2d Ed. 1961), with citation of cases such as *Charles Hughes & Co.* v. *S.E.C.*, 2 Cir., 139 F. 2d 434, 437, certiorari denied 321 U.S. 786; *Hughes* v. *S.E.C.*, D.C. Cir., 174 F. 2d 969; *Norris & Hirshberg, Inc.* v. *S.E.C.*, D.C. Cir., 177 F. 2d 228, and other cases cited in 3 Loss, *id.* 1435 n. 19. A fiduciary who recommends the purchase of a particular stock because or after he has secretly taken a position in that stock which will make his recommendation profitable for him is guilty of deception if he conceals the secret motive underlying his advice. Indeed, this appears to be the law even without statute. *Ridgely* v. *Keene*, 1909, 134 App. Div. 647, 119 N.Y.S. 451, 453.

In 1960, upon recommendation of the SEC and with the announced purpose of tightening up the Act, a series of amendments were passed. 2 Loss, *id.* 1395; 3 Loss, *id.* 1515–1518. There was then added to this statute by amendment of Sept. 6, 1960, 74 Stat. 887, a fourth paragraph, 15 U.S.C. § 80b–6(4), which is important enough here to quote: "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Since most of the events here involved took place before the statute became effective, the SEC has not relied on it to sustain the requested injunction, though it would seem that the first sentence could be cited to support the prospective remedy here sought which

operates only in the future. It should be particularly noted that the provision adds powers and terms of regulation; it nowhere cuts down or reduces them.

Curiously enough my brothers seize upon this statute to cut down the clear grant of authority expressed in words already defined in the earlier statutes. While seemingly agreeing that the new statute gives the Commission the authority to proceed against practices of the general type here involved, they state that this authority cannot be exercised until a specific rule outlawing this precise behavior has been promulgated. But the statute is eloquently silent as to any such condition, and is in terms broadly prohibitive. And the argument misconceives the significance of the grant of rule-making power. It is Congress which declares the policy and defines the prohibitions, while the SEC is authorized to adopt regulations not to vary, but to aid in the execution of, the policy. Cf. *S.E.C.* v. *Chenery Corp.*, 332 U.S. 194. Here the SEC, with commendable expedition, having in mind the necessity of extensive hearings and full consideration of the various interests needing to be heard, has substantially completed work upon at least preliminary regulations under this statute. It is to be noted that those already published seem shrewdly framed in terms of ways and means for the better effectuation of the policy, rather than its variation.[1] In my judgment, therefore, the new statute has been put to a wholly improper argumentative use; it supports rather than undercuts the Commission's position.

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[1] The opinion cites SEC Release No. 121, Nov. 2, 1961, dealing with fraudulent, deceptive, or manipulative advertising by investment advisers. It should have cited SEC Release No. 120, Oct. 16, 1961, requiring registration of stock dealings by advisers *and their staffs*. These proposed regulations are obviously means and devices to effectuate the declared policy of the statute, not to make different policy.

My brothers find various procedural objections to an injunction *pendente lite* here, citing a variety of legal clichés which have certain fields of operation, but which are quite inapposite here. Thus the injunction was not refused by the district judge as a matter of discretion weighing the equities; it was refused on the basis of an erroneous ruling of law, and a claim of right thereto by the defendants. Of course we must and do correct such mistakes as a matter of course on appeal from a denial of injunctive relief, see, e.g., *Ring* v. *Spina,* 2 Cir., 148 F. 2d 647, 160 A.L.R. 371. Then there is the statement that a preliminary injunction should not grant what is being sought permanently. This means only that a case should not be prejudged prior to a full hearing beyond what is necessary fairly to preserve the parties' right. Of course it cannot mean—and this is belied in daily practice—that an injunction cannot issue when the plaintiff's right to ultimate relief is shown; that would be to say in effect that the better the plaintiff's case, the less chance he has for any remedy until a possibly protracted trial is completed. Here there is a strong public interest involved, both on the part of the investing public and on the part of other investment advisers whose reputation is being sadly traduced by the defendants' activities. On the other hand, the defendants are little prejudiced by the nonpunitive injunction sought, which merely directs them in the future to follow that course of conduct which they ought to wish to do anyhow, particularly if they would retain any shred of reputation as a trustworthy adviser. Further it will relieve this important commercial court of the stigma of supporting low business practices. The decision below should be reversed for the grant of an injunction *pendente lite.*

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 30—September Term, 1961

(Rehearing en banc February 22, 1962
Decided July 13, 1962)

Docket No. 26942

SECURITIES AND EXCHANGE COMMISSION,
Appellant,

against

CAPITAL GAINS RESEARCH BUREAU, INC., and
HARRY F. SCHWARZMANN,
Appellees.

Before:

LUMBARD, *Chief Judge,* and
CLARK, WATERMAN, MOORE, FRIENDLY, SMITH,
KAUFMAN, HAYS and MARSHALL, *Circuit Judges.*

MOORE, *Circuit Judge*:

Plaintiff, (appellant), Securities and Exchange Commission (SEC), in its complaint, alleging violation of Section 206 (1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C.A. 80b-6 (1) and (2), sought a temporary restraining order, preliminary injunction and final injunction against defendants

(appellees), Capital Gains Research Bureau, Inc., and Harry P. Schwarzmann, to prevent them from employing "any device, scheme or artifice to defraud any client or prospective client" and from engaging "in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." By order to show cause based upon the complaint and an affidavit of an SEC investigator, a temporary restraining order was granted and a hearing upon an application for a preliminary injunction was directed. No additional proof was offered by the SEC upon the hearing; Schwarzmann, as owner of Capital Gains and as a defendant, submitted an affidavit opposing the application. The District Court upon this proof denied the motion for a preliminary injunction and vacated the stay. 191 F. Supp. 897 (1961). The SEC appealed. A panel of this court affirmed the district court's order. 300 F. 2d 745. A petition of the SEC for a rehearing *en banc* was granted.

The only question presented at this stage of the proceedings, namely, an application for a preliminary injunction in advance of a trial upon the merits, is whether a violation of section 206(1) and (2) has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial.

The SEC brings this proceeding under subsections (1) and (2) of Section 206. These subsections make it unlawful "(1) to employ any device, scheme, or artifice to defraud any client or prospective client" or "(2) to engage in any business which operates as a fraud or deceit upon any client or prospective client."

Capital Gains publishes an investment advisory service. It distributes two bulletins, one entitled "Facts on the Funds" (not involved in this proceed-

ing), which informs subscribers as to changes in the portfolios of Mutual Funds and another headed "Special Recommendation" or "Special Bulletin" which gives financial facts and figures concerning the specific company made the subject of the analysis. Only certain bulletins involving the special situations are before the court.

The SEC did not present in support of its application for a preliminary injunction any of the reports upon which it relied as showing a failure to disclose material facts. However, this deficiency was remedied by defendants who attached the special bulletins to their answering affidavit. In substance, the bulletins contain figures showing the corporate earnings over a period of years of the companies therein analyzed, an outline of the nature and current status of the business, future prospects, earnings and price-to earnings ratios, (in some cases) the number of Funds which own the stock, and usually a brief resume of assets and profits.

All seven companies[1] analyzed are substantial companies in their respective fields and their stocks have been listed and traded on the New York Stock Exchange for many years. No charge is made by the SEC that any misstatements or false figures were contained in any of the bulletins; that the investment advice was unsound; that defendants were being bribed or paid to tout a stock contrary to their own beliefs; or that these bulletins were a scheme to get rid of worthless stock. The SEC premises its entire case upon the fact that shortly before the bulletins were mailed, defendants purchased shares of the stock and, in one instance where they suggested that the

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[1] Continental Insurance, Creole Petroleum, Union Pacific, Hart, Schaffner & Marx, United Fruit, Shattuck and Chock Full O'Nuts.

stock was too high, sold short. The SEC then points to the facts that there were small market rises in each of the stocks following publication and that defendants sold the stocks previously purchased (or covered as to the short sale) by them within a week or two thereafter.

The SEC correctly argues that federal securities laws are to be construed broadly to effectuate their remedial purpose. Nor can there be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised. A good example of a violation of this principle is found in *SEC* v. *Torr*:[9]

> When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived.

Or if it were established that Capital Gains made its recommendations for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such conduct might well find itself within the prohibitions of Section 206 (1) and (2).

But here the SEC's proof tends only to show that, at most, defendant Schwarzmann profited personally from the predictable market effect of his honest advice. There is no proof that defendants employed "any device, scheme or artifice to defraud any client or prospective client" or engaged "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective

[9] 15 F. Supp. 315, 317 (S.D.N.Y. 1936), rev'd on other grounds (2 Cir. 1937), 87 F. 2d 446.

client." The SEC's case, both here and in the court below, has been based entirely upon section 206, subsections (1) and (2) of the Act. And in interpreting these sections we must take account of the recent warning of the Supreme Court against excessive judicial expansion of provisions of the securities laws to accomplish objectives believed to be salutary. *Blau* v. *Lehman*, 368 U.S. 403 (1962).

Although there is no direct occasion to consider whether defendants' activities were "manipulative" under the prohibition added to the Act by the Act of September 15, 1960, 74 Stat. 885, 15 U.S.C. § 80b-6 (4), or could be prohibited by an SEC rule under that section, the amendment is not without significance. To section 80b-6 containing subsections (1) and (2) were added (3) (not here relevant) and (4) which made it unlawful for any investment adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

By the enactment of subparagraph (4), section 80b-6, the SEC now has been directed by Congress "by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." The SEC has not shown itself reluctant to consider and draft "rules and regulations" toward this end. Already it has issued regulations dealing with registration of stock dealings by investment advisers and their staffs and with types of advertising deemed to be fradulent or deceptive. (See SEC Releases Nos. 120, 121, October 16, 1961, November 2, 1961.) The extent, if any, to which the SEC may believe it desirable to go in regulating purchases or sales of securities by investment advisory publishers at or about the time of comment in their publications concerning such securities has been entrusted by Congress to the SEC. However, here the SEC's case

is predicated solely on the deliberately meagre provisions of § 206 (1) and (2) as enacted in 1940, 54 Stat. 853, and not on § 206(4) added by the Act of September 15, 1960, 74 Stat. 885. Whether conduct such as defendant's is now forbidden as a "manipulative" practice under the first clause of (4) or only if prohibited by detailed rules and regulations promulgated by the Commission, is an issue neither presented nor determined.

The legislative history of the Investment Advisers Act strongly supports our interpretation of the langauge of subsections (1) and (2). The Investment Advisers Act of 1940 was not as comprehensive as the Securities Act of 1933 or the Securities Exchange Act of 1934. It did not have to deal with the purchase and sale of securities and broker-dealer-customer relationships. Rather the Act was thought to be a modest beginning—not a great and final piece of legislation. "It followed a brief supplemental report on investment advisers which the Commission had filed as an incident of its investment trust study." Loss, "Securities Regulations," Vol. II, pp. 1392–1393. The report did not even propose legislation in any formal way, let alone define its scope. It merely described the investment counselling business in the United States and set forth state legislation on the subject, as well as showing how the Investment Counsellors of America regulated themselves internally. A representative of the SEC, testifying before the Senate committee in 1940, said the SEC knew very little about the investment-advising business and, therefore, the "fundamental approach" of the proposed legislation was to get a "compulsory census" of the industry. "Aside from that fundamental approach the only other provisions in that title are just a few broad generalizations which say that you cannot embezzle your client's

funds or you cannot be guilty of fraud." Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580, pt. 1, 76th Cong., 2d Sess. (1940), p. 48. Hence, as Loss also tells us, "For twenty years this statute was little more than a continuing census of the Nation's investment advisers" until it "was substantially tightened up by a series of amendments in 1960, fifteen years after the Commission had first urged such action in a special report to Congress."

The history of the 1960 amendment confirms the narrow scope of the initial enactment, in an area highly relevant here. This history begins with a report by the Senate Subcommittee on Legislative Oversight in which there was a short section on the Investment Advisers Act. This section says (p. 53 of the report):

> "Our recommendation that the act be amended arises from the fact that as shown in the hearings held September 17, 1958 (transcript, pp. 3753–3767), investment advisers are not now required to disclose the financial interest of affiliates in securities concerning which they give advice."

This conclusion had arisen from hearings on the Crowell-Collier issue of convertible debentures. An affiliate of the issuer was an investment adviser, and had recommended the issue without disclosing its interest. The Subcommittee commented (p. 54):

> "The failure to disclose to Investment Survey subscribers an obvious 'dual interest' with respect to Crowell securities did not constitute a specific violation of the act; see testimony by SEC personnel, transcript pages 3755, 3756."

The Subcommittee called for amendment of the act to make sure that such behavior would be a violation, quoting a statement of SEC Chairman, Edward N.

Gadsby, that it was now time to strengthen the act to make it more than "a mere census taking." See Independent Regulatory Commissions, Report of the Special Subcommittee on Legislative Oversight of the Senate Committee on Interstate and Foreign Commerce, H.R. Rep. No. 2711, 85th Cong., 2d Sess. (1959), pp. 53–54.

The SEC staff prepared a memorandum describing the reasons for the various amendments that were being proposed in 1959. The section relating to the new subsection (4) for § 206, Hearings Before a Subcommittee of the Senate Committee on Banking and Currency on S. 1176, etc., 86th Cong., 1st Sess. (1959), pp. 516–517, read in part as follows:

> "Section 9. Creation of rulemaking power over antifraud provisions:
>
> The substantive prohibitions of the Investment Advisers Act are very limited. They are in essence contained in sections 205 and 206, which outlaw certain types of unfair investment advisory contracts, and prohibit an investment adviser from perpetrating fraud or from selling securities directly to clients without disclosing the capacity in which he is acting and obtaining the client's consent.
>
> Because of the general language of the statutory antifraud provision and the absence of any express rulemaking power in connection with them, the SEC has always had doubt as to the scope of the fraudulent and deceptive activities that are prohibited and as to how far it is limited in this area by common law concepts of fraud and deceit. These include proof of a (1) false representation of; (2) a material; (3) fact; (4) the defendant must make it to induce reliance; (5) the plaintiff must rely on the false representation; (6) and suffer damage as a consequence.
>
> In order to overcome this difficulty, section 9 of the bill would amend section 206 to add a

prohibition against engaging in conduct which is fraudulent, deceptive or manipulative and to authorize the Commission by rules and regulations to define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative. This is about the identical wording of section 15(c)(2) of the Securities Exchange Act in regard to brokers and dealers.

In the SEC's estimation, such a provision would enable it to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients."

The committee reports show that Congress shared that assumption. The House Report, 86th Cong., 2d Sess. No. 2179, says the following:

"Section 9. Addition of rulemaking power to implement antifraud provisions:

Present law.—Present section 206 contains general prohibitions against fraudulent activities.

Problem.—Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in ths area by common law concepts of fraud and deceit.

Remedy in the bill.—It is proposed that a new paragraph (4) be added to section 206 which would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of businesses which are fraudulent, deceptive, or manipulative. This is comparable to section 15(c)(2) of the Securities Exchange Act of 1934 which applies to brokers and dealers."

The Senate Report, No. 1760, U.S. Code Congressional and Administrative News 3502, accepts verbatim the SEC's reasons above quoted (p. 3509) and says generally that, "of the five acts administered by the Securities and Exchange Commission * * * the Investment Advisers Act of 1940 is the most inadequate," p. 3503. Coming to Section 9, it says this would authorize the Commission to issue regulations which would prohibit fraudulent, deceptive, and manipulative conduct," thereby affording a necessary supplement to the "very limited" provisions of §§ 205 and 206 which "outlaw certain types of unfair investment advisory contracts, and prohibit an investment adviser from perpetrating fraud or from selling securities directly to clients without disclosing the capacity in which he is acting and obtaining the client's consent" (p. 3509). Finally, the report says, "This provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his client" (p. 3510).

No proof having been presented under sections 206 (1) and (2) sufficient to justify the granting of a preliminary injunction, the order appealed from is affirmed.

Clark, *Circuit Judge*, whom Judges Smith, Kaufman, and Marshall join, dissenting:

Decision in the present case turns on the meaning and scope of the Investment Advisers Act of 1940, last of the six great regulatory statutes of the era 1933–1940 controlling the marketing of investment securities. We need to recall the dramatic origin of these statutes as an outcome of the greatest stock market crash in history and the exhaustive studies then made of the evils of stock market manipulation

and fraudulent stock selling. It seems universally conceded—and the favorable judicial attitude records the fact—that this legislation was brilliantly successful in responding to a genuine social need. It is a prime demonstration of the capacity of a democratic government to meet a social crisis skillfully and positively. While it may not have solved every problem, it went a long way in facing the issues involved and protecting the investor from being victimized.

After this history of successful achievement it comes as a real shock to find a majority of this court ready to scuttle the last of these highly useful statutes and leave it as but a shell. In a summary opinion which ignores this history and the interconnection of these statutes, they officially declare this Act to be quite ineffective, thus terminating all present regulation of investment advisers and also casting doubt upon the other important acts framed in the same langauge. True, they pay verbal obeisance to the principle that these regulatory laws are to be construed broadly to effectuate their remedial purpose; in actual fact they cut down the operation of the Act's central provision, § 206, 15 U.S.C. § 80b–6, in the very area where its over-all purpose might be furthered. Beyond this the majority show an antagonistic attitude toward securities regulation which bodes ill for the future effectiveness of even the earlier statutes, heretofore generously supported. I believe it fairly demonstrable that so destructive a decision not merely is not compelled, but actually is quite contrary to sound legal principles of statutory interpretation as we have up to now known them.

Initially I find it necessary to set out in greater detail than do the majority the substantially undisputed facts upon which the SEC premised its complaint and motion for a preliminary injunction.

Capital Gains Research Bureau, Inc., a leading registered investment advisory service, published two bulletins which it distributes to subscribers. One, entitled "Facts on Funds," explores changes effected in the portfolio of Mutual Funds; the other, "A Capital Gains Report," is a regular service which periodically evaluates securities. The Capital Gains Report is denominated: "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued." There are about 20,000 subscribers to the "Facts on Funds" bulletin, and about 5,000 subscribers to the "Capital Gains Report"; the latter publication is frequently distributed to a large group of about 100,000 nonsubscribers by use of general mailing lists.

During the period covered in the complaint Capital Gains analyzed several securities and made recommendations to its subscribers concerning them. At the same time, without disclosing the transactions to its customers, it traded in these securities to its profit. The Commission contends that this pattern of secret trading violated the antifraud provisions of the Investment Advisers Act of 1940, § 206 (1) and (2), 15 U.S.C. § 80b–6(1, 2). The transactions were as follows:

(1) On March 15, 1960, Capital Gains purchased 500 shares of Continental Insurance Co. stock at price of \$47¾ and \$47⅞ per share. Three days later it circulated a report recommending purchase of the stock "for gradual but substantial appreciation." For two days after the mailing of the report the volume of trading increased substantially and the market price rose, and on March 29 Capital Gains sold the stock at \$50⅛.

(2) Between May 13 and May 20, 1960, Capital Gains purchased 5,300 shares of United Fruit Co. stock, at a total cost of $117,114.00. On May 27, a report was circulated recommending United Fruit for both long- and short-term gains. Again immediately following the mailing date of the report, trading volume rose markedly and the price increased. (The average daily volume for 11 days preceding the issuance of the report was 5,955 shares; for the 4 days following, average volume was over twice this—13,150.) Between June 6 and June 10, Capital Gains sold the 5,300 shares at a profit of $10,725.00.

(3) On July 5 and July 14, Capital Gains bought 2,000 shares of Creole Petroleum. Then, on July 15, the company issued an optimistic report on Creole. Again volume increased immediately after the report, and again the price rose. Between July 20 and 22, Capital Gains unloaded its shares at a profit.

(4) On August 6, 1960, Capital Gains purchased 600 shares of Hart, Schaffner & Marx stock at $23. On August 12, it issued a report recommending purchase of this security. Again volume increased substantially following the issuance of the report, and the price rose. Within 10 days Capital Gains sold 600 shares at a profit.

(5) Between October 4 and October 13, Capital Gains entered into several transactions involving the stock of the Chock Full O'Nuts Corp. It sold 500 shares short at a net price of $34,200.00. It also purchased 11—3 month "puts." Like the short sale, the purchase of a put reflected a bet by Capital Gains that the price of the stock would decline in the period. On October 14, it sent to its subscribers and others a report comparing the value of Chock Full O'Nuts to that of Frank G. Shattuck Co. (Schrafft's). The report suggested that Chock Full O'Nuts was overvalued.

Again, the day after the report was mailed volume increased and the price, which had been rising, fell and went into a decline; on October 24, Capital Gains covered its short sale at a profit.

(6) Finally, on October 28 and October 31, 1960, Capital Gains purchased a total of 2,000 shares of Union Pacific stock at a price slightly above $25 per share. On November 1, a report was issued recommending this stock. Once again, immediately following the mailing of the report, the volume increased markedly, and the price rose. On November 7, Capital Gains sold the 2,000 shares at 27.[1]

Thus we have evidence of a practice known on Wall Street as "scalping," by which an investment adviser makes a short-term profit on the direct or secondary market reaction to its advice. The question for decision is whether this pattern of undisclosed purchases or short sales of securities shortly before recommendation, invariably followed by a rise in market volume and an appreciable rise or fall in price, followed shortly by sale or cover at a profit, constitutes sufficient evidence to warrant a finding of violation of the antifraud provisions of the Act. It is to prevent this practice that the SEC seeks the mild prophylactic of an injunction, without other penalties or sanctions.

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[1] While the evidence submitted was based on affidavits, the material facts were not denied by an answering affidavit. Here a detailed statement of a prolonged course of conduct was set forth by the Commission; the injunction was sought in the public interest by an independent regulatory body; and the affidavits were clearly sufficient to support a preliminary injunction. Of course the majority really do not deny this, for they accept the facts as stated in their determination of the merits of this appeal. The suggestion that the defendants had to supply the deficiencies of proof seems an unnecessary and irrelevant slur on the activities of a busy and overworked agency.

Here there is no substantial dispute over the facts, and the injunction was denied solely because the district court believed that on these facts no violation of the Investment Advisers Act was made out. This was based on a seriously limiting interpretation of the antifraud provisions of the Act. Thus, as we have often ruled, we must grant full review of this legal determination at this time. See, e.g., *Rings* v. *Spina,* 2 Cir. 148 F. 2d 647, 650, 160 A.L.R. 371; *Carroll* v. *American Federation of Musicians,* 2 Cir., 295 F. 2d 484, 488-489; *Societe Comptoir de l'Industrie Cotonniere* v. *Alexander's Department Stores, Inc.,* 2 Cir. 299 F. 2d 33; *Empresa Hondurena de Vapores, S.A.* v. *McLeod,* 2 Cir., 300 F. 2d 222. It is not a question of finding defendants at fault without awaiting full development of the facts. The uncontroverted facts before us require determination of the scope of the Act. And this is what the majority have done, for the denial of an injunction is grounded not on the state of the record, but on their view of the substantive scope of § 206.

As suggested above, it is necessary to view this legislation against its background, so totally ignored in the majority opinion. Faced with the great stock market crash and accompanying business depression, Congress reacted to the careful studies of stock manipulation before it by passing this series of six great regulatory acts for the protection of the securities investor. These were the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. These statutes form an interrelated pattern of regulation of the securities industry, all of which are essential for the adequate protection of the investor.

One of the chief methods of regulation followed in the several acts was the requirement of full disclosure. In contrast to the common law, which was premised on the ancient maxim *caveat emptor*, the regulatory legislation adopted the philosophy of consumer protection, "let the seller also beware." H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933), quoted in *Wilko* v. *Swan*, 346 U.S. 427, 430. Under this philosophy the seller of securities was required fully to disclose all relevant data, and a variety of devices was fashioned to achieve this end. For example, issuers must file detailed registration statements and circulate accurate prospectuses. Securities listed on an exchange must be registered and reports filed, and those soliciting proxies must disclose certain data. To stiffen and supplement these specific requirements, several antifraud provisions were enacted. Specific penalties and liabilities were provided for failure to disclose the required information. At the same time several general antifraud provisions were passed; among these were § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q (a); §§ 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78o(c) (1); and the sections here under consideration.

These general antifraud sections, which in substantive scope contain many similarities, have been liberally construed to effectuate the broad remedial purpose of the acts. Section 17(a) has been held not to be limited to the narrow confines of common-law fraud. *Charles Hughes & Co.* v. *S.E.C.*, 2 Cir., 139 F. 2d 434, 435–436, certiorari denied 321 U.S. 786; see *Hughes* v. *S.E.C.*, D.C. Cir., 174 F. 2d 969, 974; *Norris & Hirshberg, Inc.* v. *S.E.C.*, D.C. Cir., 177 F. 2d 228; *Archer* v. *S.E.C.*, 8 Cir., 133 F. 2d 795, certiorari denied 319 U.S. 767; *S.E.C.* v. *Torr*, D.C.S.D.N.Y., 15 F. Supp. 315, reversed on other grounds 2 Cir., 87 F. 2d 446, reaffirmed on remand

D.C.S.D.N.Y., 22 F. Supp. 602; 3 Loss, Securities Regulation 1435 (2d Ed. 1961). The common-law doctrines of fraud and deceit grew up in a business climate very different from that involved in the sale of securities, and the rigors of those doctrines were ill fitted to regulation of the sale of this unique and intricate merchandise. See generally Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933).

The Investment Advisers Act of 1940, the final step in the regulation of the securities market, reflects the purposes and policies of its predecessors. Thus the Senate Committee on Banking and Currency concluded: "The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale." Sen. Rept. No. 1775, 76th Cong., 3d Sess. 20 (1940).

The majority present an extensive analysis of the "legislative history" of the Act to support their narrow construction of § 206. Very little of this is actually history; and some of that is, as I shall point out later, a misquotation of statements by Professor Loss. The remainder of the extensive discussion is not of history, but of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act. Not only are these citations misleading, but reliance on them violates canons of construction laid down by the Supreme Court.

The 1959 statements by the SEC do not support the majority's interpretation of the statute.[2] They do reflect some confusion and concern over the precise scope of § 206, but they never adopt the restrictive interpretation suggested. And it would be naive not to recognize that these statements were made at the close and under pressure of an era of limited initiative and retreat by the regulatory agencies.[3] Even if the SEC had by rule or regulation explicitly adopted a narrow construction of § 206, it would seem highly doubtful that it could thereby defeat the intention of the prior Congress. See *Greene* v. *Dietz,* 2 Cir., 247 F. 2d 689. *A fortiori,* expression of some hesitation or doubt in a later memorandum could hardly have such an effect. Cf. *Wong Yang Sung* v. *McGrath,* 339 U.S. 33, 47–48.

Similarly, the opinions attributed to a Congress twenty years after the event cannot be considered evidence of the intent of the Congress of 1940. There is nothing in the extensive citations of the majority which indicates that the later Congress accepted a narrow interpretation of § 206. The reports merely echo SEC "doubts." Section 206 (4), the 1960 amendment, utilizes language remarkably similar to that of

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[2] Indeed, in 1955, the Commission argued that § 206, "enacted for the specific protection of the investing public," was definitely "not limited to the restrictive concepts of common law fraud." *Seipel* v. *S.E.C.*, D.C. Cir., 229 F. 2d 758, Brief for Appellee, p. 12. This argument was successful; the D.C. Circuit held that § 206 proscribed activity which would not have been actionable at common law. See 3 Loss, Securities Regulation 1516 (2d Ed. 1961).

[3] See, e.g., *Rosenblum* v. *F.T.C.*, 2 Cir., 214 F. 2d 338; *Blau* v. *Mission Corp.*, 2 Cir., 212 F. 2d 77, 81, certiorari denied *Mission Corp.* v. *Blau*, 347 U.S. 1016; *Roberts* v. *Eaton*, 2 Cir., 212 F. 2d 82, 84, certiorari denied 348 U.S. 827; *Greene* v. *Dietz*, 2 Cir., 247 F. 2d 689, 696.

the original statute; the chief material difference is the addition of rule-making power, and it may well be that Congress either rejected the doubts or held no views on the scope of the prior legislation. And even if Congress in 1960 had explicitly commented on the scope of the prior Act, its interpretation would be of little, if any, weight in determination of the meaning of the prior cognate legislation. *Rainwater* v. *United States*, 356 U.S. 590, 593. Thus the data marshaled by the majority prove no more than that a regulatory commission, perhaps sensing a favorable legislative climate, took an opportunity to secure fuller enforcement powers in order to simplify regulation. To determine the intention of the Congress of 1940 we must look backwards from the date of passage, not forwards.

The 1940 Act was designed to protect "the public" "from the frauds and misrepresentations of unscrupulous tipsters and touts" and to safeguard bona fide investment counsel "against the stigma of the activities of these individuals." Sen. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940). It required registration and prohibited investment advisers from engaging in certain conduct, including that defined in §§ 205 and 206. If, as the majority imply, the statute did not achieve its regulatory purpose, but remained "little more than a census," in Professor Loss's words, this was not due to any deficiency in the antifraud provisions here under consideration, which Loss concludes are very broad reaching, 3 Loss, Securities Regulation 1515 (2d Ed. 1961), but because until 1960 the Commission had inadequate power to inspect the books and records of advisers or to require reports, 2 Loss, Securities Regulation 1408 (2d Ed. 1961). As Professor Loss points out, "a statute of this sort without an inspection power is a statute without teeth." *Ibid.*

The antifraud sections of this statute are substantially similar to, or identical with, § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and, absent counterindications, should be construed *in pari materia.* Certainly with the earlier Acts before it, Congress would intend identical language to have identical import. Both outlaw use of a "device, scheme, or artifice to defraud" and acts which operate as a "fraud or deceit." Compare clauses (1) and (3) of § 17(a) of the earlier Act with clauses (1) and (2) of § 206 of the later Act. The sole substantial difference between the statute under review and its predecessor is that clause (2) of § 17(a) is not included in the later enactment. Even without explicit statement in the legislative history as to why this clause was omitted, the reasons seem obvious. This clause in essence restates common-law deceit as it was defined in the most liberal jurisdictions, prohibiting obtaining money or property by misleading statements or omissions. See 3 Loss, Securities Regulation 1433-1435 (2d Ed. 1961). It was both necessary and natural to include such a provision in statutes regulating the activities of "dealers" and "brokers." It is irrelevant, however, in the context of regulation of investment "advisers," who by definition do not buy and sell securities for their customers, Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b-2(a)(11), and thus are not normally in a position to obtain money directly by wrongful means. This change not reflecting any material alteration otherwise in the scope of the statute, Investment Advisers Act of 1940, § 206 (1) and (2), 15 U.S.C. § 80b-6(1, 2), should be given the same broad construction, *mutatis mutandis,* as its predecessor. 3

Loss, Securities Regulation 1515 (2d Ed. 1961).[4] And of course it is the recognition that if investment advisers are to "defraud" anyone it will not be in the normal buyer-seller context which is crucial to this case. For it is in the secondary effects of advice, not in direct dealings, that the real potentials for fraud lie in this field. To reach and prevent that is the purpose of this legislation; defrauding in direct dealings is covered by the earlier Acts regulating brokers and dealers.

The majority, verbally emphasizing that the Act should be construed to achieve its remedial ends, recognize that manipulation, if intentional, would come within the scope of the Act. Certainly such activity—whatever it may be held to mean—would not be covered if the statute were narrowly limited. Compare Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b). Having recognized that purposeful manipulation would violate the Act, the opinion then states that there has been insufficient proof here of such activity to warrant granting an injunction. It is utterly unclear to me what further proof is needed. For what could be clearer from the facts as set forth by the SEC than that Capital Gains knew that its recommendations would affect the market and timed their issuance so it would profit therefrom? Cf. *S.E.C.* v. *Torr*, *supra*, D.C.S.D.N.Y., 22 F. Supp. 602, 608.

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[4] It seems a curious inversion of all principles of statutory construction to hold that the omission here of this unnecessary provision is proof of a legislative intent to limit the new Act strictly to the omitted prohibition. This topsy-turvy argument was made and rejected in *Seipel* v. *S.E.C.*, D.C. Cir., 229 F. 2d 758. See 3 Loss, Securities Regulation 1516 (2d Ed. 1961). *Seipel* held that the S.E.C. need not show all elements of common-law fraud to prove a violation of § 206 of the Investment Advisers Act.

"Intent," if it need be found, can certainly be inferred from the facts as stated.

The majority's construction, however, is much narrower, for the gist of the opinion is that even intentional, secret manipulation is lawful if it is not "artificial." Thus it seems that an adviser can escape liability for scalping unless the SEC affirmatively proves he disbelieved his own recommendations. Since there are many creditable stocks upon which a plausible analysis can be built, such a burden will be almost impossible for the Commission to meet.

Not only is this construction inconsistent with the Congressional intent to regulate the effect of advisers on the markets and on unsuspecting customers and with the settled trend of interpretation of parallel antifraud provisions; it also conflicts with the holding of one of the chief cases on which the majority itself relies, *S.E.C.* v. *Torr*, D.C.S.D.N.Y., 15 F. Supp. 315, 317, reversed on other grounds 2 Cir., 87 F. 2d 446, reaffirmed on remand D.C.S.D.N.Y., 22 F. Supp. 602.[5]

Capital Gains violated its duty to disclose its secret trading. In a case brought prior to the passage of the 1940 statute the D.C. Circuit held that an investment adviser is in a fiduciary relationship with his clients and violates the antifraud sections of the 1933 and 1934 Acts by failing to reveal that he simultaneously exercised the role of broker-dealer, thus gaining a material interest in their response to his advice. *Hughes* v. *S.E.C.*, *supra*, D.C. Cir., 174 F. 2d 969. And in *Charles Hughes & Co.* v. *S.E.C.*, *supra*, 2 Cir., 139

[5] In reversing the grant of a preliminary injunction, this court did not question the existence of a statutory violation, but held that, since the defendants had ceased engaging in the questioned practices and gave no indication of resuming them, the injunction was improvidently granted. On remand, Judge Woolsey reaffirmed the holding that the defendants' conduct violated § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a).

F. 2d 434, [illegible], certiorari denied 321 U.S. 786, we held that a registered broker-dealer which had secured the confidence of its customers in the reliability of its recommendations committed statutory fraud by withholding the fact that the price charged its customers was above the prevailing market. "Once that confidence was established, the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fradulent device."

Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally installed in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

Thus the majority's approving citation of *S.E.C.* v. *Torr, supra,* D.C.S.D.N.Y., 15 F. Supp. 315, is strange. For the finding of a statutory violation there is equally applicable in this case. In *Torr,* defendants were paid a bonus for all activity in a particular stock on the New York Curb Exchange which could be fairly attributed to the effects of their influence in touting the security. The court held that they committed statutory fraud when, in honestly recommending a perfectly good security, they suppressed the fact that they had such a direct financial interest in induc-

ing clients to rely on their advice. The economic situation in this case is precisely the same.

Some of my brothers seemingly draw some comfort in believing that the destructive effect of this construction of the statute will be limited in effect and duration because of powers now granted to the SEC by the 1960 amendment to the statute, § 206(4), 15 U.S.C. § 80b–6(4). That amendment adds another prohibition which makes it unlawful for advisers to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and authorizes the SEC to issue rules and regulations defining and prescribing means to prevent such behavior. The thought seems to be that the SEC will hereafter outlaw the defendants' activities by regulation. This suggests an easy solution to a problem which is obviously bemusing the court. But like many an "easy" solution it becomes in reality the harder one because of the difficulties it creates. Among those difficulties are those of time, of power and validity of the indicated action, of legislative policy in the premises, and of potential paralysis of agency action and the execution of Congressional policies.

On the matter of time it is obvious that under the most favorable conditions—that even if it be eventually adjudicated that the SEC can declare activities criminal which the court now holds perfectly legal—it will be several years before any regulation hitting the defendants' practices can be properly drafted, enacted, and then upheld judicially. Obviously not in our generation can any effective regulation along this line be expected. As counsel pointed out in argument, the mere drafting is a matter requiring time and unusual skill, even before the product is submitted to public scrutiny through official hearings and other means. In the two regulations it has adopted under this new statute the SEC has wisely limited

itself to means and devices to effectuate what it accepts as the declared policy of the statute and is not making new policy. One of these, SEC release No. 120, Oct. 16, 1961, requires registration of stock dealings by advisers *and their staffs,* thus giving it information as to the persons actually engaged in the investment counseling; while the other, SEC Release No. 121, Nov. 2, 1961, deals with *advertising* by investment advisers and is aimed to prevent advertising contrary to the statutory intent, i.e., fraudulent, deceptive, or manipulative. Neither of these would reach defendants' practices here; to do so would require a change in SEC policy, not merely to implement Congressional bans, but itself to initiate and define a ban and make it operative.

And that leads to the difficult problem of validity of such a prohibition. In *Greene* v. *Dietz, supra,* 2 Cir., 247 F. 2d 689, we were troubled by the power of the SEC to make regulations not authorized by Congress or possibly contrary to the Congressional mandate. That question, which we did not try to resolve definitively, would arise in acute form here in view of the decision that scalping is a permitted and uncriticizable practice under present legislation. This, as I have indicated, means in substance that only common-law fraud, i.e., misrepresentation relied on to one's loss, is interdicted by the provisions of § 206 (1) and (2).[6]

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[6] The panel opinion by Judge Moore, 2 Cir., 300 F. 2d 745, has been adversely cited by commentators as indicating, *contra* to settled and uniform authority, that the antifraud provisions of the Securities Acts are limited to the narrow elements of common-law fraud. This is the position taken by Professor Loss in the 1962 Supplement to his treatise, 3 Loss, Securities Regulation 1435 n. 19 (1962 Supp.), and by Note, 75 Harv. L. Rev. 1449, 1450 n. 6 (1962). See also Note, 71 Yale L.J. 1342, 1347 (1962). While the majority opinion here is more guarded as to rationale and more generous in disclaiming illib-

What is changed under the new amendment? Obviously the words "fraudulent" and "deceptive" add nothing more; the only addition is the word "manipulative." But it is difficult to perceive how a court which does not regard scalping as fraudulent can conceive of it as manipulative; it must believe that the practice amounts only to ordinary buying and selling in the natural course of business. There thus would be serious question as to the validity of a regulation prohibiting and making criminal practices not prohibited by Congress—a question needless to say which does not arise under what seems to me the more natural interpretation of the Congressional purpose which I urge.

The other two objections I shall discuss together more hurriedly. In both the original and the amended additional form of the statute, the prohibition (whatever its meaning) is made direct and unequivocal: "it *shall be unlawful* for any investment adviser" subject to the Act to engage in the fraudulent, deceptive, or manipulative act, practice, or course of business. The mandate is not made subject to the condition precedent of some validating action by the SEC; it cannot add to or subtract from the Congressional action. When Congress wished to provide such a condition precedent it knew how to do it. Thus in § 10(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(a), it made unlawful the use of means to effect a short sale "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

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erality than its predecessor, the effect of the opinion is precisely the same. Moreover, no attempt is made to distinguish the language of § 206 from identical phrases in the other anti-fraud statutes and rules.

And in subdivision (b) it enacted a like provision as to manipulative or deceptive devices or contrivances in connection with the purchase and sale of any securities. The addition by way of gloss here of such a condition precedent suggests a general rule (there being no special reason for limiting it to the present case) which would go well beyond this case in destructive possibilities. Now in general the regulatory agencies seek injunctions to effectuate legislative policy;[7] if first there must be some definite and precise agency regulation the execution of Congressional policy will be hampered and delayed, if not made impossible.

In short, the hope of a regulation which will require Capital Gains to meet appropriate fiduciary standards not contained in the statute is illusory indeed. I see no ameliorating factor to lessen the harshness of the decision, and am completely at a loss to understand the reason for it. As I have indicated, it is not a required result; actually the contrary would have been much simpler under the precedents, particularly because of the troublesome doubt now

[7] All of the six securities acts contain provisions authorizing injunctive relief without conditions, such as are here being formulated. See, e.g., Securities Act of 1933 § 20, 15 U.S.C. § 77t; Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa; Investment Advisers Act of 1940, § 209, 15 U.S.C. § 80b–9. Many, perhaps most, other statutes administered by government agencies authorize injunctive relief. See, e.g., Agricultural Adjustment Act, § 8a(6), 7 U.S.C. § 608 a(6); Civil Aeronautics Act of 1938, § 1007, 49 U.S.C. § 647; Communications Act of 1934, § 401, 47 U.S.C. § 401; Federal Trade Commission Act, § 13, 15 U.S.C. § 53; Interstate Commerce Act, § 16(12), 49 U.S.C. § 16(12); Labor Management Relations Act of 1947, § 101(*l*), 29 U.S.C. § 160(*l*). Arguments against a required rule-making in this connection are stated in 75 Harv. L. Rev. 1449, 1451 (1962), discussing *Cady, Roberts & Co.*, SEC Release No. 6668, Nov. 8, 1961.

cast upon the meaning of the antifraud provisions of the Securities and Securities Exchange Acts. Perhaps its worst feature is that it sanctions and indeed endorses a low standard of business morality, as the business world has apparently been quick to see.[8] The form of scalping here engaged in is a shocking business, as well as the chief method by which an investment adviser may bilk his clients. This regulatory statute was explicitly aimed to protect the loyal investment adviser against the tipsters and touts and the less desirable members of the profession generally. In all probability it will be those devoted fiduciaries who will be hardest hit by this decision which levels all to one low standard. By holding scalping not a violation of § 206 (1) and (2), the majority not only have sadly emasculated a promising statute, but have also cast doubt generally upon all governmental regulation in the general public interest.

I therefore reiterate the position I took in dissenting initially from the decision of the panel majority, 2 Cir., 300 F. 2d 751–754. I believe the decision below should be reversed, and an injunction *pendente lite* granted.

[8] See the syndicated columns of the financial writer Sylvia Porter in the New York Post for Jan. 4, 1962, "Stock 'Scalping' Upheld by Court"; Jan. 5, 1962, "Investment and Ethics"; and Feb. 16, 1962, "Stock 'Scalping' Faces Court Test." Cf. Leslie Gould, Financial Editor, "SEC Puts Postscript on 'You Only Have to Get Rich Once' Book," N.Y. Journal-American, May 24, 1962, p. 29.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 26942

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF-APPELLANT,

v.

CAPITAL GAINS RESEARCH BUREAU, INC., AND HARRY P. SCHWARZMANN, DEFENDANTS-APPELLEES

Before LUMBARD, *Chief Judge,* and CLARK, WATERMAN, MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS, and MARSHALL, *Circuit Judges.*

Appeal from the United States District Court for the Southern District of New York.

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of July, one thousand nine hundred and sixty-two.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO,
Clerk.

APPENDIX C

1. The Securities Act of 1933 (48 Stat. 74, 84, 15 U.S.C. 77a, *et seq.*) provides in pertinent part:

> An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.
>
> * * * * *
>
> FRAUDULENT INTERSTATE TRANSACTIONS
>
> SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
>
> * * * * *

2. The Securities Exchange Act of 1934 (48 Stat. 881, 891, 895, as amended, 15 U.S.C. 78a *et seq.*) provides in pertinent part:

An Act to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

* * * * *

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * * *

OVER-THE-COUNTER MARKETS

SECTION 15.

* * * * *

(c)(2) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with which such broker or dealer

engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

* * * * *

3. Rule 10b-5 (17 C.F.R. 240.10b-5) issued pursuant to the Securities Exchange Act of 1934 provides:

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

U.S. GOVERNMENT PRINTING OFFICE: 1982

No. 42

IN THE

Supreme Court of the United States

October Term, 1962

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CAPITAL GAINS RESEARCH BUREAU, INC., and HARRY P. SCHWARZMANN

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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CITATIONS.

STATUTES AND RULES.

No. 618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962.

SECURITIES AND EXCHANGE COMMISSION,
Petitioner

v.

CAPITAL GAINS RESEARCH BUREAU, INC., and
HARRY P. SCHWARZMANN.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner seeks a review of an interlocutory order affirming an order of the United States District Court for the Southern District of New York denying an injunction *pendente lite* (in an action commenced over two years ago) for failure of proof to warrant a preliminary injunction. A panel of the Circuit Court had previously affirmed.

Opinions Below.

The opinion of the Court of Appeals *en banc* is reported at 306 F. 2d 606. The petition correctly cites the decisions of the Circuit Court panel and of the District Court.

Reference to Appendix of Appellees in Circuit Court is designated "Resp. R". Nine additional copies are being filed herewith. Reference to Securities and Exchange Commission Appendix is designated "R".

Question Presented.

Should this Court review the denial of an injunction *pendente lite,* for lack of sufficient proof to warrant a preliminary injunction, for alleged violation of Section 206(1) and (2) of the Investment Advisers Act of 1940—where the preliminary injunction has been denied by the District Court, affirmed by a panel of the Circuit Court, and the Circuit Court *en banc*—and where the action was commenced over two years ago and the petitioner has failed to proceed to trial on the merits.

Decisions of the Courts Below.

The Circuit Court *en banc* held:

> "The only question presented at this stage of the proceedings, namely, an application for a preliminary injunction in advance of a trial upon the merits, is whether a violation of Section 206 (1) and (2) has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial." (306 F. 2d 606, 608)
>
> "* * * There is no proof that defendants employed 'any device, scheme, or artifice to defraud any client or prospective client' or engaged 'in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.'" (p. 609)
>
> "No proof having been presented under sections 206(1) and (2) sufficient to justify the granting of a preliminary injunction, the order appealed from is affirmed." (p. 611)

The District Court found there was no fraud or deceit and none was intended.

> "There is no proof here that any client * * * lost a single dollar * * * or that defendants intended that any client * * * should * * *.
>
> "* * * there is nothing to indicate that defendants intended anything but maximum profits for their clients * * *." (191 F. Supp. 897, 899)

Statute Involved.

The penal provisions are in T. 15 USC, 80b-17.

> "80b-6. Prohibited transactions by registered investment advisers
>
> "It shall be unlawful for any investment adviser registered under section 80b-3 of this title, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly.—
>
> "(1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> "(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> "(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any trans-

T. 15, USC, 80b-6.
Petitioner alleged violations of only Sub. (1) and (2).

action with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; Aug. 22, 1940, c. 686, Title II, §206, 54 Stat. 852;

"(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission *shall*, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative. As amended Sept. 6, 1960, Pub. L. 86-750, §§8, 9, 74 Stat. 887."

Statement.

There is a substantial dispute as to material facts as related by petitioner.

Harry P. Schwarzmann, or his company, has been a registered investment adviser since 1953 (Resp. R, 6a). Mr. Schwarzmann, a man of good repute, left a substantial position as head of a corporation to organize and build his own business (Resp. R, 3a).

Capital Gains issues two publications. One, "Facts on the Funds", contains solely statistical information of portfolio changes of the leading mutual funds. It was distributed periodically to about twenty thousand subscribers for a fee of $24 per year (Resp. R, 6a).

The other publication, called "A Capital Gains Report", was subscribed to by about five thousand at $18 per annum (Resp. R, 6a). This publication was issued after research of a particular stock, management consultation, giving statistical and analytical data, and generally contains a recommendation to purchase for long-term appreciation (Resp. R, 6a).

The implication of the SEC (adopted by the minority) that bulletins were issued to non-subscribers, sometimes to 100,000, to create buying is absolutely false (Resp. R, 6a). Reason and arithmetic confirm the fallacy of the premise. The cost of issuing 100,000 bulletins (postage, printing, mailing of \$7,000-\$8,000) would have caused respondents a substantial loss on each of six transactions and a very considerable total loss on the combined total. The bulletins were occasionally issued to non-subscribers, as a sample of research done, to obtain new subscribers, but only some appreciable time after they had been issued to subscribers (Resp. R, 6a).

It is not disputed that the recommendations to subscribers were sound; that, in seven years as an investment adviser, Mr. Schwarzmann had never written on a questionable stock; that each recommendation was carefully selected, thoroughly researched and investigated (Resp. R, 1a). All of the stocks are nationally known and listed on the New York Stock Exchange, save one on the American Stock Exchange. The reports were an unbiased selection made in good faith to provide subscribers an opportunity for long-term capital appreciation (Resp. R, 1a). Subscribers had, in each instance complained of, the opportunity for substantial profit, as shown in the following chart.

Name of Stock	Price When Recommended	Subsequent High	% Increase	% Profit Realized by Capital Gains on its Transactions
Continental Insurance	\$48½	\$74⅞	54.4%	2.0%
United Fruit	22¾	30½	34.1	8.8
Creole Petroleum	25⅝	42¾	66.8	1.0
Hart, Schaffner & Marx	23	36½	58.7	6.0
Frank G. Shattuck	17	31⅜	84.5	6.8
Union Pacific	25	37⅛	48.5	3.2

There was no proof that the transactions of Capital Gains in any way interfered with the profit that might have been made by any subscriber who followed the recommendation.

There was nothing secret about the Capital Gains transactions. Stocks were openly bought and sold in the name of Capital Gains through member firms of the Exchange (Resp. R, 2a). Capital Gains had no knowledge whether any subscriber followed its recommendations. Nor was there any proof that any subscriber did in fact purchase any stock recommended.

The number of shares purchased by Capital Gains prior to the reports was insignificant compared to the outstanding stock of the companies involved:

	Shares Purchased	Outstanding Shares
Continental Insurance	500	11,998,000
Creole Petroleum	2,000	77,621,000
Union Pacific	2,000	22,439,000
Hart, Schaffner & Marx	600	875,695
United Fruit	5,300	8,733,000
Shattuck	600	1,104,000

Petitioner omitted to state that in two instances (Continental Insurance and Shattuck) Capital Gains purchased shares after issuing the report, as well as before, and in one instance (Creole) had not recommended that the stock be purchased (R, 22, 24).

There was no proof that Capital Gains' recommendations influenced the market; there are hundreds of investment advisers and thousands of brokers who recommend stocks. We know in one instance (Union Pacific) purchase of the stock had been recommended by Standard & Poor's, the largest advisory service, ten days before Capital Gains' recommendations (R, 23). Three leading New York Stock

Exchange houses recommended Continental Insurance after Capital Gains (R, 23).

Petitioners chart on page 5 misstates the facts. It overstates the total profits by about 100%. The profit on Continental Insurance was $89 instead of $1,125; on Creole Petroleum $569 instead of $1,762; on Union Pacific $1,599 instead of $1,757, and on Chock Full O'Nuts a loss of $4,080 instead of a profit of $2,773.33 (R. 23, 25, 24, 22).

This suit was started precipitously after a two-day investigation (Resp. R, 3a). Prior to the suit the SEC was told that, while Capital Gains believed that it had a right to make use of its own research for its own market profit—i.e., to trade in an open market—and had not committed any fraud or deceit, it was nevertheless willing to conform to SEC wishes as to trading or not trading or any form of disclosure of transactions (Resp. R, 1a, 2a, 5a). The practice complained of was thus discontinued without the necessity of this suit, but, regardless, the SEC embarked upon this litigation with trial by ruinous publicity.

The day after the issuance of the order to show cause, before answering affidavits had been submitted, there appeared on the front page of the local paper in Mr. Schwarzmann's hometown the following:

> "According to Henry B. Bright of New York, senior attorney for the SEC, who brought the complaint against Schwarzmann, 'this is the biggest fraud of its kind which we have discovered on the market in the last 10 years.'"

There was other publicity in New York papers on matters not appearing in the moving papers and supplied by SEC (Resp. R, 4a).

Chock Full O'Nuts.

Illustrative of the SEC's failure to prove a scheme to defraud any subscriber and that the real complaint is not that anyone was defrauded but that respondent might profit is this factual situation.

Capital Gains did not recommend either the sale or the short sale of this stock. It had never recommended that its subscribers purchase the stock and had no knowledge whether any subscriber owned a single share (R. 21, 22).

Capital Gains transactions in the stock had no relation to its subscribers. It had also completed transactions in the stock some time before the bulletin. The transactions complained of resulted not in a $2,700 profit, as claimed, but in a loss of $4,000 (R. 22). The bulletin in question was a study as to the relative values of Chock Full O'Nuts and Shattuck (Schrafft's), pointing out that at current prices there was far greater opportunity for profit in Shattuck and recommending it for purchase (R. 21, 22, 35, 36).

Reasons for Denying Writ.

Petitioner, in an action over two years old, is still seeking a preliminary injunction, which has been denied by three courts, to prevent possible "immediate and irreparable injury, loss and damage" to respondents' subscribers prior to a trial on merits (R. 7). Although the case could have been tried long ago, petitioner has made no attempt to proceed to trial.

There is no substantial or important question involved. The decision below does not hinge upon construction of a statute but on failure of proof to warrant a preliminary injunction pending a trial on the merits. The decision is not in conflict with that of any other circuit—nor is it novel.

There was a finding by the District Court of good faith—a lack of intent to defraud, without which there can be no violation of the statute.

Further, there was no proof of injury or probable injury to any of respondents' subscribers—on the contrary, in the instances complained of subscribers could have made, in each instance, on respondents' advice, a capital gain of from 34% to 84%.

In addition, there was no need for a preliminary injunction—the question was moot before the bringing of the action.

1. This Court does not review the denial of a preliminary injunction for failure of proof.

The exceptional power to review an interlocutory order by certiorari is intended to be sparingly exercised, and has never been extended to failure of proof.[1]

The decision of the Court below does not hinge on construction of the statute involved but on a failure of proof.

The decision of the Circuit Court *en banc* said:

> "The only question presented at this stage of the proceedings, namely, an application for a preliminary injunction in advance of a trial upon the merits, is whether a violation of section 206(1) and (2) has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial." (306 F. 2d 606, 608)
>
> "* * * There is no proof that defendants employed 'any device, scheme, or artifice to defraud any client or prospective client' or engaged 'in any transaction, practice, or course of business which operates as a

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[1] *Denver* v. *N. Y. Trust Co.*, 229 U. S. 123, 133 (1912).

fraud or deceit upon any client or prospective client.'" (p. 609)

"* * * No proof having been presented under sections 206(1) and (2) sufficient to justify the granting of a preliminary injunction, the order appealed from is affirmed." (p. 611)

The issuance of preliminary injunctions depend upon the facts in each case. Being episodic, failure of proof provides no special or important reason for review.[2]

2. Under the rule of this Court, findings of the District Court undisturbed by the Court of Appeals are unassailable.[3]

The District Court's finding of good faith and lack of intent to defraud is dispositive of this case.

The District Court found:

"There is no proof here that any client * * * lost a single dollar * * * or that defendants intended that any client * * * should * * *.

"* * * there is nothing to indicate that defendants intended anything but maximum profits for their clients * * *." (191 F. Supp. 897, 899.)

The finding was amply supported by evidence. It is not disputed that the recommendations were sound. In each instance complained of, subscribers had the opportunity for long term capital gains of from 34-84% (*supra*, p. 5). There was no proof that respondent's transactions in the slightest way interfered with the possible profits of the subscriber, nor that the non-disclosure on

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[2] *Rice* v. *Sioux City Memorial Park Cemetery, Inc.*, 349 U. S. 70, 74 (1954).

[3] *Alabama Power Co.* v. *Ickes*, 302 U. S. 464, 475 (1938); *Comstock* v. *Group of Institutional Investors*, 335 U. S. 211, 214 (1948).

the transactions was a material fact that did or could operate as a fraud or deceit upon a subscriber.

Fraud is never presumed and must be established by clear, convincing and satisfactory proof.[4]

Intent to deceive or defraud is a necessary ingredient to fraud. *Durland* v. *United States*, 161 U. S. 306, 313, 314 (1895); *United States* v. *Brandt*, 196 F. 2d 653, 657 (1952, 2nd); *Troutman* v. *United States*, 100 F. 2d 628, 632 (1938, 10th) cert. den. 306, U. S. 649[5]; *Rice* v. *United States*, 149 F. 2d 601, 603 (1945, 10th).[5]

Three Courts have found that the petitioner failed to establish proof sufficient to warrant granting a preliminary injunction before a trial on the merits.

3. There was no abuse of discretion in denying the injunction *pendente lite.*

The Court's function in reviewing the grant or denial of a preliminary injunction is limited to the question of whether discretion was improvidently exercised. Discretion is implicit in the decision even if not expressed.[(6)]

The moving papers sought the preliminary injunction because "immediate and irreparable injury, loss and damage may result to clients or prospective clients" of respondent. (R7).

In addition to finding good faith and lack of intent to defraud without which there can be no violation the Dis-

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[4] *United States* v. *Thompson*, 279 F. 2d, 165, 167 (1960, 10th); *Equitable Life Insur. Co.* v. *Halsey, Stuart & Co.*, 112 F. 2nd, 302, 308 (1940, 7th).

[5] These cases involved fraud provisions of the Securities Act of 1933, 15 U. S. C. 77q.

[6] *United States* v. *Corrick*, 298 U. S. 435, 437 (1936); *Alabama* v. *United States*, 279 U. S. 229, 231 (1929); *Meccano, Ltd.* v. *John Wanamaker*, 253 U. S. 136, 142 (1920).

trict Court found no injury or probable risk of injury to respondent's subscribers.

> "There is no proof here that any client * * * lost a single dollar by reason of the defendant's acts * * * or that defendants intended that any client or prospective client should * * *." 191 F. Supp. 897, 899.

A preliminary injunction should not be issued without need. An injuction is not justified by the fact that a defendant is in a position where he could commit a violation or that plaintiff thinks that he might.[7]

Nor should a preliminary injunction be granted where its effect is to give final relief before a trial of the issues.[8]

4. This Court will not review the right to a preliminary injunction where the necessity for such relief does not exist.[9]

The suit and preliminary injunction were unnecessary. Prior to the commencement of the suit in November, 1960, when question arose about the transactions, respondents, while asserting no fraud or deceit had been perpetrated, were willing to abide by any suggested practice as to trading or not trading or a disclosure thereof that the S. E. C. deemed advisable! (Resp. R. 2a, 5a, 7a).

Instead of handling the situation as an administrative matter (the Commission has the right to revoke an adviser's registration (T. 15 USC 80b-3(d)), and the practice com-

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[7] *United States* v. *U. S. Steel*, 251 U. S. 417, 445 (1920); *Securities and Exchange Commission* v. *Torr*, 87 F. 2nd, 446 (1937, 2nd).

[8] *Securities and Exchange Commission* v. *Torr, supra*; *United States* v. *Adler's Creamery*; 107 F. 2d, 987, 990 (1939, 2nd); cert. den. 311 U. S. 657.

[9] *United States* v. *Alaska S. S. Co.*, 253 U. S. 113, 116 (1920).

plained of had ceased, the Commission nevertheless on a two-day investigation embarked upon this litigation.

The litigation is over two years old and the Commission is still seeking a preliminary injunction, yet making no effort to proceed on the merits. Petitioner does not deny that the acts complained of ceased.

The purpose of injunction relief is not to punish for past acts, assuming they were unlawful, but in a proper case to prevent future violations.[10] When the acts complained of have ceased, there is no reason for the suit or for injunction, no triable issue, and the case is moot.[11]

5. The petitioner has "unclean hands". The traditional rules of equity apply to actions involving governmental agencies.[12] A seeker of equity must do equity. The day after this action was commenced, not content with publicizing information contained in the moving papers, there appeared on the front page of the local newspaper in the home town of the respondent, the following:

> "According to Henry B. Bright of New York, senior attorney for the SEC, who brought the complaint against Schwarzmann, 'this is the biggest fraud of its kind which we have discovered on the market in the last 10 years.' " (Resp. R. 4a)

This was before respondent had an opportunity to file an answering affidavit, which affidavit has never been contradicted.

Such publicity is contrary to the Investment Advisers Act, T15 USC 80b-10(b), which provides the Commission or employee

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[10] *Walling* v. *Buettner*, 133 F. 2d 306 (1943, 7th).

[11] *Walling* v. *Schenandoah-Dives Mining Co.*, 134 F. 2d, 395 (1943, 10th).

[12] *Alabama* v. *United States, supra* (p. 230).

> "shall not make public * * * the results of or any facts ascertained during any such * * * investigation; * * *"[13]

Despite these clearly defined restrictions on publicity, designed and spelled out to protect innocent people, to prevent the destroying of reputation and creating prejudice to a fair hearing, other statements not appearing in the moving papers appeared in the public press emanating from Petitioner's office (Resp. R. 4a). These press releases are in violation of Canon 20 of the American Bar Association Canons of Professional Ethics proscribing trying cases in the newspaper to the prejudice of respondents rights and the administration of justice.

Errors in Petitioner's Reasons for Writ.

A. Petitioner claims the issue presented is whether "scalping" is a violation of the statute involved. Nowhere in the moving papers is the word "scalping" mentioned. No rule of the S. E. C. mentions or defines the word; no proof was offered as to its meaning. The word is misused by petitioner, adopted without proof of meaning by the minority, and has no relation to this case.[14]

B. The decision below does not hinge upon statutory construction but on the failure of petitioner's proof to warrant on the facts of this case a preliminary injunction prior to a trial on the merits. However, the statute is a

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[13] The restriction on publicity may explain the resort to Court action, instead of administrative proceedings.

[14] Scalping has no sinister connotation. It merely means trading in quick succession for a small trading profit of a fraction or a point or two. *Munn's Encyclopedia of Banking and Finance*, p. 667.

penal one[15] and may not be extended beyond its terms.[16] Where statutes are penal, fraud cannot have one meaning for the Securities and Exchange Commission and another for the Department of Justice.[17]

C. The opinion below does not sanction any low business practice, violation of the statute, breach of fiduciary duty, nor is it in conflict with decisions of any other circuit.

Petitioner and the minority opinion ignore the finding of good faith and lack of intent to defraud, and the facts.

Respondents, after careful research and finding a stock undervalued, decided to recommend it to subscribers for long capital gain. Respondents then, in the instances cited, purchased a small number of shares. An investment adviser has the right to use his own work product to trade in an open market (barring some regulation to the contrary). Common sense would dictate that a subscriber would expect an adviser to do so.

The subscriber's purchase is not contrary to advice he plans to give—to recommend purchase for a capital gain. (If he purchased none, by petitioner's theory he might be suspect for not following his advice.) The point of departure here is that the adviser did not hold for a long-term gain. There is no legal or moral obligation that an adviser buy every stock he recommends and hold it for as long as he recommends at the hazard of being accused of fraud.

On oral argument petitioner conceded that there would be no fraud if the adviser followed exactly his recomendation, i.e., buy and hold for six months. Can it turn fraudulent if the adviser buys but holds for five months and 29

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[15] T15 USC 80 b-17.

[16] *United States* v. *Resnick*, 299 U. S. 207 (1936).

[17] *Federal Communications Commission* v. *American Broadcasting Co. Inc.*, 347 U. S. 284, 296 (1953).

days instead of six months? Or if he holds only for four months, two months, one month, or ten days? Obviously not. The crucial test is, was the advice honest and given in good faith with honest intent, i.e., that subscribers have the opportunity for long-term gain.

The soundness of the advice is not questioned; in fact, subscribers could have profited 34-84% on the recommendations.

Petitioner, conceding the advice was honest, urges that it was not disinterested because respondents bought some shares. But the uncontradicted facts are that the adviser researched and decided to recommend the stock prior to his own purchases. The stock would have been recommended regardless of whether respondents purchased.

The suggestion that respondents' recommendation was motivated by his own small trade and small profit, compared to the profit the subscribers, following the advice, could have had, is contrary to and a jaundiced view of the facts. The advice was not motivated by self-interest, but given in the course of business in the belief subscribers could profit thereby, which proved one hundred per cent correct.

There was no proof that the respondents' transactions interfered with or were adverse to the subscribers' opportunity for capital gain.

There was no breach of fiduciary duty. The obligation owed to subscribers was to give honest advice with good intent and this was done and was unmarred by the adviser, too, making a profit on his own research in a manner which in no way interfered with subscribers' possibilities of profit.

The respondents' transactions were not a material fact as to whether his advice was honest or whether subscribers could make a maximum profit therefrom. Respondents' transactions were his private affair which it would not dawn on one of good conscience to disclose in the absence

of any known rule or regulation of the S. E. C. requiring disclosure.

The accepted form of disclosure, when broker-dealers trade in a recommended stock, that they "may from time to time hold a position in the securities mentioned herein" can hardly be the difference between integrity and fraud (Resp. R, 6a). This meaningless phrase which the SEC considers sanctifying is worship of "disclosure" as a shibboleth—of form to substance.

No disclosure can make a dishonest transaction honest, nor lack of disclosure make an honest one dishonest.[18]

The non-disclosure to constitute fraud must not only be as to a material fact but it must be with intent to deceive.[19]

The New York Stock Exchange Guide provides:

> "If a member organization recommends a security in which it has a *substantial position* * * * it should consider whether such interest * * * ought to be stated in the material."[20] (Emphasis supplied.)

The sales of stock by Capital Gains were not in conflict with the interest of subscribers. The sales occurred five to fourteen days after the report was issued, so that the subscriber had ample opportunity to buy for long-term

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[18] *Epstein* v. *United States*, 174 F. 2d 754, 768 (6th, 1949).

[19] *Otis & Co.* v. *Securities and Exchange Commission*, 160 F. 2d 579, 582 (6th, 1939).

[20] New York Stock Exchange Guide, Section 2474 A.10. Petitioner's brief (p. 18) refers to a newspaper description of New York Stock Exchange Educational Circular No. 170 which inadequately describes the release. The Stock Exchange rule has not been altered. The head of the Stock Exchange so testified before the SEC and said that need for further disclosure was "debatable." "New York Herald Tribune", 5-26-62. Circular 170 reported censure of a firm where partners, employees and their families unloaded stock on recommending it. The SEC stated "no misconduct is charged" and took no action. "New York Times", 5-23-62.

gains prior thereto. Certainly the transactions were not in conflict with the long-term capital gains of the subscriber in the respective stock.

There was no element of manipulation in the respondents' transactions. Not only was there no proof that the reports in fact influenced the market, but, assuming they had, a correct report issued in the course of business to the effect that a stock is undervalued, even if it causes a market to rise, is not manipulative. Manipulation means to artificially raise prices.[21] Every corporate report showing an increase of profits or prospects thereof, however true, if it causes a market to rise could be considered manipulative. But in any case the manipulation would have to be one that deceived or defrauded the subscriber, which is patently not the case.

Contrary to the suggestion that Capital Gains was seeking to cause a rise in the market, clients had been specifically reminded not to be in haste in buying thereby disturbing the market (R. 25-26, 34).

No fraud or deceit has been shown and what really is troubling the petitioner is not that a fraud has been perpetrated on any subscriber but that the respondent has also in some instances made a profit on his own work product.

A distinct example of the unclear thinking of petitioner is the instance of Chock Full O'Nuts. There the respondents had never recommended that any subscriber buy the stock and had no knowledge of whether any subscriber owned the stock (R. 21, 22). The bulletin did not recommend the sale, nor the short sale. It was a comparative study of the current value of Chock Full O'Nuts and Frank

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[21] See Securities and Exchange Act of 1934, 15 USC 78 i,j; and Rules thereunder.

G. Shattuck Co. (Schrafft's), pointing out that the latter offered far greater chance of appreciation and recommending the purchase of Shattuck (R. 21, 22, 35, 36).

On Shattuck the subscribers had an opportunity for profit, on the correct prediction of the adviser, to the extent of 50% in two months and 84% on a long-term gain or six-month period. From this state of facts it is obvious that there could be no fraud or deceit upon a subscriber because of respondents' transaction.

D. The decision below does not conflict with the decision of any other circuit. The petitioner cites *Torr, Charles Hughes, Arleen Hughes, Archer* and *Todd* as conflicting and indistinguishable. The cases involved different statutes and are as different as night and day.

In *Torr*, a preliminary injunction was denied. Torr was engaged to dispose of 47,000 shares of stock on which a man had an option at a given price and Torr was to receive one-third of the profits. It was necessary to raise the price of the stock on the Exchange in order for Torr to profit, and the higher the price was raised the more Torr profited. To accomplish this, Torr paid salesmen throughout the country to urge the purchase of stock on the market without disclosing to anyone that his motive and intent for doing it was to raise the price of stock so that Torr could profit. The deception is clear.

Charles Hughes involved a review of an SEC order of revocation of a broker-dealer registration. There was direct selling of stock to the customers without disclosing a mark-up of 16 to 40% over the price at which the customer could have bought on the market. The fraud is clear.

Arleen Hughes was a review of an SEC revocation of the broker-dealer's registration where defendant had been repeatedly warned by the SEC against her course of con-

duct and refused to stop. She sold securities directly to customers substantially above market prices without disclosure.[22] The fraud is glaring.

Archer involved the revocation of a broker-dealer license for a false registration statement and fraud in over-the-counter transactions where he deviated from the market price to his personal advantage without disclosure. The fraud was clear.

In *Securities and Exchange Commission v. Frank Payson Todd,* on the SEC statement of the case (p. 17) it would seem clearly deceitful for Todd was recommending one group of clients to buy a stock and at the same time was selling out the stock in another group of clients' accounts. He was deceiving one or the other group.[23]

The distinction between the case at bar and the foregoing cases is obvious. In the case at bar there has been no fraud or deceit. The adviser gave sound, unbiased, profitable advice to the subscriber.

Conclusion.

There was no violation of the statute nor need for a preliminary injunction which was rendered moot before the case was commenced by the respondents' ceasing to purchase stock, before recommendation and his willingness to conform as to trading, not trading, or any form of dis-

[22] The defendant was readmitted to registration as a broker-dealer, 30 SEC 390, 1949.

[23] Shortly after defendant consented to an injunction it was vacated at his request (and without objection by the Commission) in order to permit a trial on the merits and eventually the Commission agreed to a dismissal of the action when it appeared that the probable facts would not support an injunction (Loos Securities Regulation Vol. 3, 2d Ed., p. 1516).

closure the SEC wished so that at best this is much ado about nothing, and, at worst, an unworthy persecution.

The petition for a writ should be dismissed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 618

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CAPITAL GAINS RESEARCH BUREAU, INC. AND HARRY P. SCHWARZMANN

REPLY TO BRIEF IN OPPOSITION

Respondents attempt to present this case as though it involves only a factual dispute as to whether the Commission had failed to prove facts sufficient to justify a preliminary injunction. However, the opinions of the courts below demonstrate that the reason the Commission was denied a preliminary injunction was because, under the courts' interpretation of the statute, the facts established by the Commission did not show a violation.[1] Thus, the court of appeals, *en banc,* refused the injunction because "the SEC's proof tends only to show that, at most, defendant

[1] There was thus no occasion for the Commission to proceed to trial on the permanent injunction, as respondents suggest (Br. 8), since under the interpretation of the statute by the court below the permanent injunction would have had to be denied.

Schwarzmann profited personally from the predictable market effect of his honest advice" and this course of conduct by respondents was not a "device, scheme or artifice to defraud," or a "practice * * * which operates as a fraud or deceit" upon the investment adviser's clients in violation of Section 206 (1) and (2) of the Investment Advisers Act of 1940 (Pet. App. 21a). It is for determination of this important statutory issue—whether the facts shown by the Commission constitute a violation of the Act—that we have brought this case to the Court.[2]

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

PETER A. DAMMANN,
General Counsel,
Securities and Exchange Commission.

JANUARY 1963.

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[2] Two factual contentions advanced by respondents are without merit. Their suggestion that there was no proof that their recommendations influenced the market (Br. 6) is answered by the statement of the court of appeals that the SEC's proof showed that respondents "profited personally from the *predictable* market effect" of their advice (Pet. App. 21a) (emphasis added).

Respondents' charge (Br. 7) that the chart at page 5 of the petition misstates the facts of the case is also without merit. Their statements of what the actual profits or losses were reflect nothing more than their insistence that certain transactions, irrelevant under the Commission's theory, be set off against their profits (R. 12, 19, 21–23, 26), or are based on conclusory figures which do not indicate where it is claimed that the detailed facts relied on by the Commission were erroneous (R. 11, 13, 23–25).

U.S. GOVERNMENT PRINTING OFFICE: 1963

No. ~~612~~ 42

IN THE

Supreme Court of the United States

OCTOBER TERM, ~~1962~~ 1963

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CAPITAL GAINS RESEARCH BUREAU, INC., and
HARRY P. SCHWARZMANN.

RESPONDENTS' SUPPLEMENTAL BRIEF.

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IN THE

Supreme Court of the United States

October Term, 1962.

No. 618.

Securities and Exchange Commission,

Petitioner,

v.

Capital Gains Research Bureau, Inc., and Harry P. Schwarzmann.

RESPONDENTS' SUPPLEMENTAL BRIEF.

Petitioner's reply brief attempts to supply lacking proof by misquoting the Court's opinion (footnote, page 2).[1] The quotation that respondents "profited personally from the *predictable* market effect" is incorrect. What the Court said was:

> "But here the SEC's proof tends only to show that, at most, defendant Schwarzmann profited personally from the predictable market effect of his honest advice. * * *" (R. 21a)

There was no proof that a single subscriber purchased any of the stocks recommended. This is undisputed. On the subject of whether there was any proof that the

[1] "It is not * * * fair for a lawyer knowingly to misquote * * * the language of a decision * * *.

" * * * These * * * practices are unprofessional * * *." (Canon of Professional Ethics, 22)

respondents' advice influenced the market, the panel of the Circuit Court said:

> "* * * Surely, no one could be so naive as to believe that a small advisory service with only 5,000 subscribers could by its own recommending influence cause such stocks as Union Pacific (22,000,000 shares outstanding), Continental Insurance (12,000,000 shares outstanding) and United Fruit (8,730,000 shares outstanding)[4] invariably and automatically to rise so that defendant could always sell their small holdings at a small profit. In the one instance, Hart, Schaffner & Marx, where the company had less than one million shares outstanding, the clients were told that purchases were recommended 'around the $23-$24 level' (the then current price). Such advice would hardly be consistent with an inference that it was intended thereby to raise the market price by their own clients' buying power. *Moreover, it is significant that the SEC introduced no proof that any client ever purchased any shares of the recommended securities.* The SEC's conclusion that these particular 5,000 subscribers must have rushed in, thereby creating an artificial stimulant, is wholly speculative and is at variance with common sense. * * *" (Emphasis supplied.)

"[4] Approximate figures."

The preliminary injunction was clearly denied for lack of proof. The petition should be dismissed.

Respectfully submitted,

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NAGER & VOORHEES,
Attorneys for Respondents.

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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 42

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CAPITAL GAINS RESEARCH BUREAU, INC. AND HARRY P. SCHWARZMANN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the district court (R. 18-21) is reported at 191 F. Supp. 897. The opinions of the panel of the court of appeals (R. 46-60) and of the court *en banc* on rehearing (R. 62-85) are reported, respectively, at 300 F. 2d 745 and 306 F. 2d 606.

JURISDICTION

The judgment of the court of appeals *en banc* was entered on July 13, 1962 (R. 86). The time within

which to file a petition for a writ of certiorari was extended by Mr. Justice Harlan to and including November 26, 1962 (R. 87, 88). The petition was filed on the latter date, and was granted on January 21, 1963 (R. 89; 371 U.S. 967). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the practice known in the investment business as "scalping" — the purchase by an investment adviser of a stock just prior to his widespread recommendation of the stock to his clients, followed by his sale of the stock at a profit upon the rise in the market price which customarily follows such recommendation, without disclosing his personal interest to his clients—is a "device, scheme, or artifice to defraud" or a "practice * * * which operates as a fraud or deceit" upon the investment adviser's clients in violation of Section 206(1) and (2) of the Investment Advisers Act of 1940.

STATUTES INVOLVED

Prior to its amendment in 1960 (see, *infra*, p. 29), Section 206 of the Investment Advisers Act of 1940, 54 Stat. 847, 15 U.S.C. 80b-6, provided in pertinent part:

> It shall be unlawful for any investment adviser * * *, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

* * * *

Other relevant statutory provisions are set forth in the Appendix, *infra*, pp. 35-37.

STATEMENT

The respondent Capital Gains Research Bureau, Inc., is registered with the Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 (R. 9, 26). The company is operated by respondent Harry P. Schwarzmann, its president and principal stockholder (R. 9, 22). The chief business of Capital Gains is the publication of two investment advisory services. The service involved in the present case is called "A Capital Gains Report," and is described by respondents as "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued" (R. 34). This service consists of a monthly (R. 26) bulletin in which respondents evaluate and recommend the purchase of a single specific security (R. 9, 26). In so doing, respondents may evaluate and report adversely on securities of comparable enterprises (R. 12, 28, 42). The Report is issued to approximately 5,000 subscribers who pay $18.00 per year for the service (R. 9-10, 26-27). In addition, the Report is sometimes also distributed

to nonsubscribers on a mailing list containing approximately 100,000 names (R. 10).

During the period from March 15, 1960, through November 7, 1960, respondents on six different occasions purchased a particular security and shortly issued a Capital Gains Report recommending the security for long-term investment. In each instance, the market price rose and the volume of trading substantially increased within a few days after distribution of respondents' bulletin. Respondents then sold the shares at a profit.[1] In one instance respondents profited not only from the purchase, recommendation and sale of a security (Frank G. Shattuck Co.), but also from selling short a security (Chock Full O'Nuts) which they stated in the bulletin was overpriced in comparison with Shattuck. Prior to the issuance of this bulletin, they had purchased three-month calls on the Shattuck stock and had sold short the stock of Chock Full O'Nuts. After publication of the bulletin, when the price of the Shattuck stock had risen and that of the Chock Full O'Nuts stock had declined, respondents exercised their call options on the former and covered their short sales of the latter, in each instance at a profit.

Typical of respondents' dealings were their transactions in the stock of Continental Insurance Co. On

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[1] One of these transactions took the form of the purchase of "calls" upon the security—that is, the right to purchase a designated number of shares during a stated period for a specified price—followed by their exercise after the price had risen. When we refer to respondents' purchases and sales involved in this case, we include the transactions accomplished through the "calls."

March 15, 1960, respondents purchased 500 shares of this stock at 47¾ and 47⅞ (R. 10). Three days later, on March 18, they mailed their report recommending purchase of the stock "for gradual but substantial appreciation" (R. 10, 34-35). Following this recommendation, the volume of trading in the stock increased (approximately threefold and fourfold, respectively, on the two business days immediately following), and the price rose (R. 15). Respondents sold the stock on March 29, 1960—11 days after their recommendation—at 50⅛, for a profit of $1,125.00 (R. 10; see note 2, *infra*, p. 7).

The timing and profits of respondents' purchases, recommendations and sales of the seven securities may be summarized as follows (the details are set forth at R. 9-17):

Stock	Purchased	Purchase Price	Recommended	Sold	Sale Price	Profit
Continental Insurance Co.	3/15/60	47-3/4, 47-7/8	3/18/60	3/29/60	50-1/8	$1,125.00
United Fruit Co.	5/13, 16, 19, 20/60	21-1/4-22-1/8	5/27/60	6/6, 7, 9, 10/60	23-5/8-24-1/2	$10,725.00
Creole Petroleum Corp.	7/5, 14/60	25-1/4-28-3/4	7/15/60	7/20, 21, 22/60	27-1/8-29	$1,762.50
Hart, Schaffner & Marx.	8/8/60	23	8/12/60	8/18, 22/60	24-7/8, 25-1/4	$837.00
Union Pacific	10/28, 31/60	25-3/8-25-5/8	11/1/60	11/7/60	27	$1,757.00
Frank G. Shattuck Co.	10/11/60 (purchased calls)	16.83 (2.53 call cost, plus 14.30 option price)	10/14/60	10/25/60 (exercised calls and sold)	19-1/2-20-1/8	$695.17
Chock Full O'Nuts	10/4/60 (sold short)	68-3/4-69 (sale price)	10/14/60 (disparaged)	10/24/60 (covered short sale)	62,62-1/2 (purchase price)	$2,772.33

[8] Respondents contend (Br. in Opp., 7) that we have overstated their profits on the transactions in Continental Insurance, Creole Petroleum, and Union Pacific, and that on Chock Full O'Nuts they incurred a loss rather than making a profit.

1. *Continental Insurance.* The difference between our figures and respondents' stems largely from their inclusion of transactions in these stocks which we deem inapplicable to the question in this case. Thus, respondents included transactions in Continental Insurance Company stock purchased *four days after* the mailing of their bulletin, which shares were sold at a loss nine days thereafter (R. 29). This loss was not included in our profit figure of $1125, which includes only transactions where respondents made their purchases prior to the publication of their bulletin. It is computed from data, which have not been disputed, set forth in the affidavit of the Commission investigator (R. 10, 15). Where the exact sale or purchase prices are not set forth in the affidavit, we have used respondents' minimum profits calculated by assuming that respondents purchased at the high of the day when the particular purchase was made and sold at the low of the day when the particular sale was made.

2. *Creole Petroleum Company.* As in the case of Continental Insurance Company, our profit figure of $1,762.50 is computed from unchallenged data set forth in the record (R. 11, 16) and similarly shows only respondents' minimum profits. Although respondent Schwarzmann stated in his affidavit that the profits on transactions in this stock were $569 (R. 31), neither the affidavit nor the record indicates how this lower amount was determined.

3. *Union Pacific.* Computations made as were those for Creole Petroleum Corporation and Continental Insurance Company, would show a minimum profit of $2,750 (R. 12-13). The table uses $1,757, however, since this smaller profit was given in the affidavit of the Commission investigator. Respondent Schwarzmann's affidavit gives a profit of $1,600 (R. 31), but without any explanation of the basis therefor.

4. *Chock Full O'Nuts.* Respondents' claim that they suffered a loss in this stock is based on their purchases of "puts" (options to sell a stock at a specified price during a stated period) which, according to Schwarzmann's affidavit, were neither sold nor exercised but became "completely worthless" (R. 28-29). When the affidavit was executed (December 13, 1960, R. 33), however, the "puts" had not yet expired; their expiration dates ranged from January 3 to January 16, 1961 (R. 12). The record does not show the value of the "puts" on the date of the affidavit, or indicate why respondents had failed to exercise them earlier.

Respondents did not disclose any aspect of any of the foregoing transactions to their clients (R. 13-14, 34-44).

In November 1960, the Commission commenced an action in the district court alleging that respondents had "employed devices, schemes and artifices to defraud clients and prospective clients" and "engaged in transactions, practices and courses of business which operate and have operated as a fraud and deceit" upon such clients in violation of Section 206(1) and (2) of the Investment Advisers Act (R. 1-4). The Commission sought an injunction to require respondents to disclose the material facts concerning their practices as part of any future bulletin (R. 3-4). The district court denied a preliminary injunction, holding that the foregoing facts did not establish a violation of the statute.[3] On appeal, a panel of the court of appeals, one judge dissenting, affirmed (R. 46-60). Subsequently, the court *en banc* reaffirmed the district court's order in a 5-4 decision (R. 62-85).[4]

While recognizing (R. 65) that the "federal securities laws are to be construed broadly to effectuate

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[3] The district court ruled that the words "fraud" and "deceit" were used in Section 206 in a "technical sense" and required proof either that respondents intended that their clients lose money or that the clients had in fact suffered losses as a result of respondents' advice (R. 20-21).

[4] The opinion of the court *en banc* (R. 62-70) was written by Judge Moore and joined in by Chief Judge Lumbard and Judges Waterman, Friendly and Hays; the dissenting opinion (R. 71-85), written by Judge Clark, was joined in by Judges Smith, Kaufman and Marshall.

their remedial purpose" and that "a relationship of trust and confidence should exist between the advisor and the advised," the majority held that respondents had not violated their fiduciary duty to their clients by failing to disclose their holdings of the stocks recommended and their practice of selling those securities shortly after their recommendations, and thus profiting "personally from the predictable market effect of [their] * * * honest advice." The court held that the statute requires the Commission to prove that the individual security recommendations were made in bad faith, and the court refused to infer bad faith from respondents' practice. The majority indicated that if, at the trial, the Commission were able to establish that the respondent firm made its recommendations "for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such conduct might well find itself within the prohibitions of Section 206(1) and (2)" (*ibid.*).

The four dissenters stated (R. 81):

> Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally instilled in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its

clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

SUMMARY OF ARGUMENT

The issue is whether respondents, in the conduct of an investment advisory service designed to aid investors in making long-term capital gains, violated Section 206(1) and (2) of the Investment Advisers Act by "scalping"—that is, by purchasing a stock shortly before recommending it, and then selling it at a profit a few days later upon the rise in price which customarily follows such a recommendation, but without disclosing the practice to their clients. Respondents, as investment advisers, were under a fiduciary obligation to render disinterested advice to their clients and they violated that duty by secretly trading upon the predictable market effect of their recommendations. In our view this breach of respondents' fiduciary duty violated Section 206(1) and (2), which makes it unlawful for an investment adviser (1) "to employ any device, scheme, or artifice to defraud any client or prospective client;" or, (2) "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

A. An investment adviser is a fiduciary, and he must therefore render completely disinterested advice. Investment advice is not disinterested, however, if the adviser follows the practice of trading upon

the predictable market effect of his own recommendations, since his personal financial interest in the effect of his advice is likely to influence his judgment. Such a practice creates conflicts of interest between his duties to his clients and his personal interest. It is immaterial that respondents may have believed in the soundness of their recommendations or made them without conscious intent to advance their personal trading interests. Respondents' non-disclosure of their trading activities constituted a fraud and deceit upon their clients because such information would be important to the clients in evaluating the recommendation. For example, clients are entitled to know that an adviser is following a practice of selling for short-term gains stock which he recommends be purchased for long-term profits, and that he had already purchased the recommended stock and might therefore be reluctant to change his recommendation before issuing it despite newly acquired adverse information.

The courts have repeatedly recognized that it is fraud and deceit under substantially identical language of Section 17(a) of the Securities Act of 1933 for a securities dealer to recommend securities without fully disclosing all pertinent facts about his interest in the transaction, and that the failure to disclose such information is not excused because the dealer "honestly" believes in the advice he gives. Indeed, the fiduciary duty of disclosure in the present case is even clearer than in those cases under the 1933 Act, since in those cases the dealers gave free investment advice, whereas in the present case respondents charged for their service.

B. Nothing in either the legislative history or the language of the 1960 amendments to the Investment Advisers Act justifies the narrow interpretation of the statute adopted by the court below. The legislative history does not show that either Congress or the Commission believed that the Act as it then stood did not proscribe non-disclosure by an investment adviser of trading on the market effect of his recommendations. Neither of the two changes made by the addition of Section 206(4) in 1960—the grant to the Commission of rule-making power and the addition of the word "manipulative" to the description of the practices specifically prohibited—justifies the conclusion that the broad anti-fraud provisions of Section 206(1) and (2) do not prohibit "scalping."

ARGUMENT

I. Respondents Violated Section 206(1) and (2) of the Investment Advisers Act By Failing To Disclose Their Trading In the Securities Which They Recommended.

The respondents provide an investment advisory service, designed to aid investors in making long-term capital gains, which they sell to 5000 subscribers for $18 a year. In addition to the income thus derived, they made personal profits of almost $20,000 during a seven-month period by repeatedly trading on the market effects of their recommendations. Their course of conduct was to purchase a security shortly before recommending it as a long-term investment, and then to sell it at a profit a few days later after the security had enjoyed the rise in price which customarily follows a recommendation by an investment service.

The advisers did not disclose to their clients any aspect of their personal transactions in the recommended securities, and the clients presumably believed that in return for their $18 a year they were receiving entirely disinterested advice.

Section 206 (1) and (2) of the Investment Advisers Act of 1940 makes it unlawful for an investment adviser, by use of the mails or the facilities of interstate commerce—

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

The question presented is a narrow one: whether respondents' failure to disclose their practice of trading upon the predictable market effect of their advice constitutes a "device, scheme, or artifice to defraud" or a "practice, or course of business which operates as a fraud or deceit" within the meaning of the foregoing provisions. In view of the suggestion of the majority below (R. 70) that the problems of "a material adverse interest in securities which the adviser is recommending" could be dealt with by rulemaking, it is important to point out that this case does not present the broad question whether, and in what circumstances, an investment adviser must disclose his interest in or ownership of securities which he recommends. That broad question may arise in many contexts, in some of which there may be no need for disclosure of the adviser's interest, and those aspects of the problem which call for regulation may properly

be dealt with through rulemaking. As we show below (*infra*, p. 33), however, the specific practice involved in the present case—an adviser's secret trading upon the predictable market effect of his own recommendations—is fraudulent irrespective of specific rules.

The Commission submits that respondents were under a fiduciary obligation to their clients to render disinterested advice, and that they violated that duty by failing to disclose their trading practices in the securities they recommended. Such a breach of respondents', fiduciary duty constituted a fraud and deceit upon their clients under Section 206(1) and (2).

A. *An Investment Adviser Has a Fiduciary Obligation to His Clients Not to Trade Secretly upon the Market Effect of His Advice.*

As the majority below recognized (R. 65), there cannot "be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised." The rendering of investment advice calls for knowledge and abilities not possessed by the average investor, who in selecting an adviser necessarily relies upon his good faith and integrity. The adviser thus acts as a fiduciary. Cf. *Arleen Hughes* v. *Securities and Exchange Commission*, 174 F. 2d 969, 971, 975, 976 (C.A. D.C.).

The only thing that an investment adviser has to sell is advice based on his expert judgment. Such advice, if it is to meet the high ethical standards which

the law imposes upon fiduciaries, must be disinterested, and the clients of an investment adviser have the right to assume that it is. Investment advice cannot be disinterested, however, if the adviser intends to profit from its effects. For in such a situation the adviser, even though he "honestly" believes in the soundness of his recommendation, may nevertheless be influenced by its probable effect on his personal fortunes.

In the present case, the record shows that the stock which respondents recommended for long-term gains in each of six monthly bulletins during a seven-month period had been purchased by them shortly before the recommendation, and that in each instance they soon sold the stock at a profit. The majority below properly recognized (R. 65) the truism of the securities business that "the predictable market effect" of such an investment adviser's recommendation ordinarily is a rise in the stock's price.[5] An investment adviser who

[5] At first blush, one might assume, as did the majority in the panel decision below (R. 50-51), that the recommendation of an investment service sent to 5000 subscribers covering a stock with millions of shares outstanding would be unlikely to have any significant effect upon its market price. The fact is, however, that "[m]arket activity, under normal trading conditions, takes place not in the entire outstanding issue of a security but in that portion known as the floating supply * * * [which is] composed principally of shares registered in the names of brokers or nominees, as distinguished from those registered in the names of the beneficial owners." Securities and Exchange Commission, *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* (1936), p. 31. And see Crane, *The Sophisticated Investor* (1959), pp. 212-213; Friend, Hoffman and Winn, *The Over-the-Counter Securities Markets*

thus personally trades upon the predictable market effect of his own recommendations inevitably creates a conflict of interest between his duty to his clients and his personal interest.

(1958), p. 35; *New York Stock Exchange Fact Book* (1961), p. 42.

The record shows that shortly after respondents' recommendations there were substantial increases in the volume of trading in the stocks recommended (R. 15-17). Economists and financial writers have recognized that the recommendations of advisory services such as respondents' do have a significant effect upon the market activity in the stocks recommended by them. See, *e.g.*, Ruff, *Effect of a Selection and Recommendation of a "Stock of the Month"*, Financial Analysts Journal, March-April, 1963, p. 41; *Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 1*, H. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess., p. 372; *Hearings on H. J. Res. 438 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 87th Cong., 1st Sess., p. 101 (testimony of Keith Funston, President, New York Stock Exchange); New York Stock Exchange, Educational Circular No. 170, November 16, 1962, discussed in the Wall Street Journal, November 19, 1962, p. 4, cols. 2, 3.

Indeed, one writer specifically listed respondents' service as among those which are likely to affect prices: "Traders have to watch carefully for tips from investment services, outfits such as Standard & Poor's Outlook, Moody's, Fitch's, United Business Service, Value Line, *Capital Gains Research*, John Magee, Garfield A. Drew and others. Many of them, like the bigger brokerage houses, have substantial followings. Their definite recommendations bring quick action." Crane, *The Sophisticated Investor* (1959), p. 67 (emphasis added).

The same writer, in describing the trading on the New York Stock Exchange on the business day following the mailing of respondents' bulletin on Hart, Schaffner & Marx, stated: "Hart Schaffner & Marx had the biggest move in response to investment advice. It gained 2-1/4 to 25-1/4 on the twin suggestions that the dividend might be increased

Respondents generally recommended a single security each month. Since they made a practice of scalping, might not their choice of a stock to recommend be influenced, consciously or unconsciously, by their judgment as to which was most likely to rise in response to their recommendation?[9] Or suppose that respondents had decided to recommend a particular security and, while the recommendation was being prepared, had purchased the stock. If at that point they learned something which reflected adversely on the stock—perhaps they received a confidential report that the company's earnings had taken a downward turn—would they change their recommendation and thus perhaps suffer a loss on the securities already purchased? We are not suggesting that these hypothetical situations occurred here. We refer to these possibilities only to point out the vices inherent in permitting an adviser to trade secretly on his own recommendations.

The maxim that "no man may serve two masters

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and that not much stock was outstanding." N.Y. Times, Aug. 16, 1960, p. 40, col. 8. (Respondents' recommendation suggested the possibility of a dividend increase, and referred to the small number of shares available. R. 41.)

Two days after the mailing of respondents' bulletin on Union Pacific stock another financial writer stated: "Union Pacific, with substantial oil interests, stood out among the rails with a gain of 1-1/8 in active trading. There was also a recommendation on the issue." N.Y. Times, Nov. 3, 1960, p. 58, col. 3.

[9] The price sensitivity of particular stocks to such a recommendation would be influenced by their "floating supply," that is, the number of shares available for trading, as distinguished from the total number outstanding. See note 5, *supra*.

* * * is especially pertinent if one of the masters happens to be economic self-interest" (*United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 549). A fiduciary who is subject to the pull of conflicting interests cannot justify his conduct on the ground that "he served his several masters equally well or that his primary loyalty was not weakened by the pull of his secondary one" (*Woods* v. *City National Bank & Trust Co.*, 312 U.S. 262, 269). The reason such conflicting interests are condemned "is not because such interests are always corrupt but because they are always corrupting" (*Mosser* v. *Darrow*, 341 U.S. 267, 271).

It is thus immaterial that respondents' advice in this case may have been "honest" in the sense that they believed it was sound and did not formulate it consciously for the purpose of furthering their personal pecuniary objectives. By secretly trading on the market effect of their recommendations, respondents violated their fiduciary obligation to provide their clients with disinterested investment advice. In *Wolf* v. *Weinstein*, 372 U.S. 633, this Court recently held that two corporate officers who had traded in the debtor's stock during reorganization were required by Section 249 of the Bankruptcy Act to refund the compensation they had received during the reorganization, even though they had rendered "beneficial services to the Debtor" and "the trading involved small amounts of stock and was carried on apparently in good faith and without knowledge of the existence of § 249 * * * " (pp. 653-654). The Court applied this "harsh" (p. 654) remedy because Section 249 was in-

tended to apply "the historic maxim of equity that a fiduciary may not receive compensation for services tainted by disloyalty or conflict of interest" (p. 641). An investment adviser who renders investment advice for compensation is subject to no lower standard of fiduciary duty.

B. ***Respondents' Secret Trading in the Securities They Recommended Constituted a Fraud and Deceit on Their Clients in Violation of Section 206(1) and (2) of the Investment Advisers Act.***

1. The Investment Advisers Act was the last of a comprehensive system of six federal regulatory statutes aimed at abuses in the securities industry. As the dissenting opinion points out (R. 78), it was "designed to protect 'the public' 'from the frauds and misrepresentations of unscrupulous tipsters and touts' and to safeguard bona fide investment counsel 'against the stigma of the activities of these individuals' ".[7] One of the evils against which Congress sought to protect investors was possible conflicts of interest between them and their advisers. Thus the Commission's report to the Congress, which provided the impetus for the legislation, stated (emphasis added):

> Broadly stated, the representatives [of the investment counseling industry] felt that investment counsel organizations could not completely perform their basic function — furnishing to clients on a personal basis competent, unbiased,

[7] The dissenting opinion is quoting from the Senate Committee report on the Act: S. Rep. No. 1775, 76th Cong., 3d Sess., p. 21.

and continuous advice regarding the sound management of their investments—*unless all conflicts of interest between the investment counsel and the client were removed.*[8]

When Congress made it illegal in Section 206(1) and (2) for any investment adviser "to employ any device, scheme, or artifice to defraud" or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon" any client, it was not using novel language. The provisions were obviously derived from the almost identical language of Section 17(a) of the Securities Act of 1933 (App. *infra*, p. 35), which makes it unlawful for any person, in the offer or sale of securities, "(1) to employ any device, scheme, or artifice to defraud, or * * * (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[9] Since these two provisions are *in pari materia*, it is appropriate to look to the decisions construing Section 17(a) of the

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[8] *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission—Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*, H. Doc. No. 477, 76th Cong., 2d Sess., p. 28.

[9] Section 10 of the Securities Exchange Act of 1934 (App. *infra*, p. 36) prohibits "any manipulative or deceptive device or contrivance * * *," and Rule 10b-5 of the Commission's rules under that Act (adopted in 1942) (App. *infra*, p. 37) contains language almost identical to the provisions of Section 17(a) of the Securities Act of 1933 quoted in the text. See also Section 15(c)(2) of the 1934 Act (App. *infra*, pp. 36-37), which prohibits any broker or dealer from engaging in any "fraudulent, deceptive, or manipulative act or practice."

Securities Act in interpreting Section 206(1) and (2) of the Investment Advisers Act.[10] See 3 Loss, *Se-*

[10] Section 17(a) of the Securities Act contains, in subsection (2), a provision not included in Section 206 of the Investment Advisers Act, namely, a prohibition against "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." This difference between the two statutes, however, does not make the decisions under the 1933 Act any less pertinent in construing Section 206. For, as discussed below in the text, those decisions recognize that the nondisclosures there involved constituted fraud and deceit within the meaning of subsections (1) and (3) of Section 17(a). Moreover, it has been held with respect to the Commission's Rule 10b-5, which contains three subdivisions substantially identical to those in Section 17(a), that "[t]he three subparagraphs of this broadly remedial rule are mutually supporting and not mutually exclusive" so that a breach of a "duty of disclosure * * * can be viewed as a violation of all three subparagraphs of the Rule, i.e., (1) a device, scheme, or artifice to defraud; (2) an implied misrepresentation or misleading omission; and (3) an act, practice or course of business which operates or would operate as a fraud upon the plaintiffs." *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del.), modified on other grounds, 235 F. 2d 369 (C.A. 3).

While the legislative history does not reveal the reason for the absence in the Investment Advisers Act of a provision comparable to Section 17(a)(2), it may have been omitted because of concern that its inclusion would have required investment advisers to give full descriptions of all securities which they recommend. Many investment advisers do not provide, and their clients do not expect, detailed information about securities recommended as "good buys." Moreover, as pointed out by the dissent below (R. 79), since Section 17(a)(2) prohibits only "obtain[ing] money or property" through non-disclosure, its primary function obviously is to regulate purchases and sales of securities rather than to regulate rendition of investment advice.

curities Regulation (2d ed. 1961), 1515.

The courts have repeatedly recognized that it is fraud and deceit under the 1933 Act for a securities dealer to recommend securities without fully disclosing all pertinent facts about his interest in the transaction, and that the failure to disclose such information is not excused because the dealer honestly believes in the advice he gives. Thus, in *Charles Hughes & Co.* v. *Securities and Exchange Commission*, 139 F. 2d 434 (C.A. 2), certiorari denied, 321 U.S. 786, a securities dealer who sold securities to his customers at prices substantially above the market without disclosing his mark-up was held to have violated Section 17(a) of the Securities Act, even though the dealer believed that his prices were fair. The court stated that this practice "operated as a fraud and deceit upon the purchasers," since the dealer was "under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions" (139 F. 2d at 436-437). In *Norris & Hirshberg* v. *Securities and Exchange Commission*, 177 F. 2d 228 (C.A. D.C.), a securities dealer engaged in "churning"—described by the court as "the continual shuffling of securities back and forth in * * * customers' accounts" (177 F. 2d at 232)—making a profit on each transaction with his customers. The court ruled that these activities could "only be described as manipulative, deceptive, and fraudulent" (*id.* at 233) in violation, *inter alia*, of Section 17(a) of the Securities Act and Rule 10b-5 under the Securities Exchange Act.

In upholding the revocation of another dealer's registration in *Arleen Hughes* v. *Securities and Exchange Commission*, 174 F. 2d 969 (C.A. D.C.), the same court held that the dealer, who was also an investment adviser, violated Section 17(a) of the Securities Act and the anti-fraud provisions of the Securities Exchange Act by failing to advise her clients of the current market prices and the cost to her of the securities she recommended and sold to them. The fact that the clients had been afforded "a high degree of investment protection, financial gain and security and financial peace of mind * * *" (*id.* at 974) provided no defense. Similarly, in *Securities and Exchange Commission* v. *Torr*, 15 F. Supp. 315 (S.D. N.Y.), reversed on other grounds, 87 F. 2d 446 (C.A. 2), reaffirmed on remand, 22 F. Supp. 602, the district court held that certain defendants violated Section 17(a) of the Securities Act of 1933 by recommending a stock allegedly "solely on its merit" (15 F. Supp. at 317), but without disclosing that they were being paid for making the recommendation. The court stated (*id.* at 317) that such nondisclosure "operated as a deceit on purchasers", since "[w]hen a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived." [11]

[11] Other decisions which have interpreted the anti-fraud provisions of federal securities legislation to impose upon fiduciaries a broad duty of disclosure in securities transac-

Indeed, long before the Investment Advisers Act it had been recognized that an investment adviser commits a fraud upon his clients if he fails to disclose his personal interest in a security he recommends. In *Ridgely* v. *Keene*, 134 App. Div. 647, 119 N.Y. Supp. 451 (2d Dept., 1909), an investment adviser published a market letter in which "he undertook to * * * give [subscribers] impartial and unbiased advice respecting stock market matters" (134 App. Div. at 648). He entered into a contract with stockbrokers by which he agreed, for compensation, to influence his subscribers to purchase a particular stock in which the brokers had a pool. The court refused to enforce the contract, holding that it was one "to perpetrate a fraud upon * * * [the] subscribers" and that the adviser's conduct was "a palpable fraud upon them" (*id.*, at 649). In rejecting the adviser's attempt to justify the conduct on the ground he "honestly believed" that his clients would profit through buying the stock, the court stated (*ibid.*):

> * * * his belief in the soundness of his advice is wholly immaterial. The law takes into account human frailty, and absolutely forbids the assumption of conflicting obligations and duties, and refuses to inquire whether the person assuming

tions include *Speed* v. *Transamerica Corp.*, 235 F. 2d 369 (C.A. 3), affirming 99 F. Supp. 808 (D. Del.); *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795 (C.A. 8), certiorari denied, 319 U.S. 767.

inconsistent relations really supposed he was faithful to both. * * * [12]

See, also, *United States* v. *Buckner*, 108 F. 2d 921 (C.A. 2), certiorari denied, 309 U.S. 669, where officials of a bondholders' protective committee were held to have violated the mail fraud statute by a scheme to acquire foreign bonds about to be defaulted, without disclosing to the bondholders that they had reason to believe that the foreign government would probably pay the bonds. The court stated (p. 926): "Using a fiduciary position as a protective committee member to obtain secret profits based upon inside information is not only a breach of trust, but an active fraud on the bondholders."

The fiduciary duty of disclosure in the present case is even clearer than in the foregoing cases involving securities dealers. For in those cases the dealers were held to have violated the anti-fraud provisions of the securities acts by giving investment advice free of charge [13] without revealing their financial interest in

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[12] Cf. *Magruder* v. *Drury*, 235 U.S. 106, 120:

> It makes no difference that the estate was not a loser in the transaction or that the commission was no more than the services were reasonably worth. It is the relation of the trustee to the estate which prevents his dealing in such way as to make a personal profit for himself. * * * While no wrong was intended, and none was in fact done to the estate, we think nevertheless that upon the principles governing the duty of a trustee, the contention that this profit could not be taken by [the trustee] * * * should have been sustained."

[13] Except, perhaps, in the *Arleen Hughes* case, *supra*, p. 23, where the dealer contended that her high charges reflected the investment advice she provided. See 174 F. 2d at 971.

the recommendations. Here, in contrast, the 5,000 subscribers to respondents' "Capital Gains Report" paid $18.00 a year for the service.

Respondents' failure to disclose to their clients their trading on the market effect of their recommendations constituted a fraud and deceit upon such clients in violation of Section 206(1) and (2), because the clients were entitled to such information in evaluating the advice. It would be highly relevant to an investor, to whom a particular stock was recommended for a long-term capital gain, to know that respondents had already purchased the stock, not for a long-term pull, but with the view of selling it in a few days for a short-term profit following the "predictable" price rise which results from such a recommendation. Moreover, the knowledge that respondents were thus trading in recommended stocks might be important to existing subscribers in determining whether to continue the service and to prospective subscribers in determining whether to purchase it. An investor who did know the facts would certainly ask himself whether respondents' practice might not have influenced their recommendation; and why they were selling what they advised others to buy and hold. It is immaterial whether respondents' answers would have satisfied their clients. While the quality of the recommendations might be such as to lead investors to continue or to purchase the service despite respondents' "scalping," the important thing is that the clients, in order to exercise an informed judgment, were entitled to know the facts.

Moreover, since the only thing an investment adviser has to sell is his own personal judgment, any fraud and deceit he may commit will almost invariably consist of misrepresenting, explicitly or implicitly, the character of the advice he is furnishing. In most instances, such misrepresentation will take the form of non-disclosure, and while the non-disclosures may relate to different aspects of the adviser's practices,[14] they have one common thread: the adviser fails to disclose to the client a fact which is material to the client in deciding whether to follow the advice.

The majority opinion recognized (R. 65) that "federal securities laws are to be construed broadly to effectuate their remedial purpose." As the dissent pointed out (R. 80), however, the effect of the majority's interpretation of Section 206(1) and (2) is "that an adviser can escape liability for scalping unless the SEC affirmatively proves he disbelieved his own recommendations." Since the Commission could rarely, if ever, make such a showing, the decision below, as the dissenters pointed out (R. 85), "sanctions and indeed endorses a low standard of business morality." By giving the remedial provisions of Section 206(1) and (2) an unduly narrow reading, it denies to clients

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[14] An adviser might make a consciously false recommendation, *i.e.*, one which he does not believe. Or he might "honestly" believe in the soundness of his advice, but fail to disclose that he has a personal interest in the recommendation, either because he is paid to make it (as in the cases discussed *supra*, pp. 22-23), or because he intends to trade personally on the market reaction to it (as in the present case).

of an investment adviser the protection against concealment of material facts which the anti-fraud provisions of the Investment Advisers Act were intended to provide.[15]

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[15] The court below stated (R. 64) that since the case involved "an application for a preliminary injunction in advance of a trial upon the merits," the "only question presented at this stage of the proceedings * * * is whether a violation * * * has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial." We believe that the decision below turns solely on the court's substantive holding that undisclosed scalping does not violate the Act. But see *Walters* v. *Moore-McCormack Lines, Inc.*, 312 F. 2d 893, 896 (C.A. 2), where Chief Judge Lumbard, in summarizing the issues involved in each of the 30 cases heard by the court *en banc*, described the present case as involving the question "whether a violation of the Investment Advisers Act * * * was so clear as to justify a preliminary injunction." See also the statements by the majority of the panel below as to the stringent showing necessary for a preliminary injunction (R. 47-48).

To the extent that the court below may have suggested that the Commission is under a particularly heavy burden of proof before it can obtain a preliminary injunction, it was clearly in error. The preliminary injunction is usually the agency's most effective enforcement tool for protecting the public against fraud, and the Commission need show only that there is a likelihood that violations have occurred and, unless restrained, are likely to continue. This is particularly so where, as in the present case, the only sanction involved is a requirement of full disclosure pending the trial on the merits. See *Securities and Exchange Commission* v. *Boren*, 283 F. 2d 312, 313 (C.A. 2). Cf. *Douds* v. *International Longshoremen's Ass'n.*, 242 F. 2d 808, 810-811 (C.A. 2); *Federal Trade Commission* v. *Rhodes Pharmacal Co.*, 191 F. 2d 744, 746-747 (C.A. 7); *Bowles* v. *Montgomery Ward & Co.*, 143 F. 2d 38, 42 (C.A. 7).

2. In 1960 Congress amended Section 206 of the Investment Advisers Act to add Subsection (4), which makes it unlawful for any investment adviser

> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

This subsection made two substantive changes in the scope of the existing provisions. It added to the prior prohibitions of "fraudulent" and "deceptive" practices a specific prohibition of "manipulative" practices; and it authorized the Commission to promulgate rules and regulations to define, and prescribe means designed to prevent, fraudulent, deceptive or manipulative acts, practices and courses of business. The majority of the court of appeals stated (R. 67-68) that the history of the 1960 amendments "confirms the narrow scope of the initial enactment"; it also apparently deemed it significant that the 1960 amendments gave the Commission broad rule-making power to deal with the subject and added "manipulation" to the categories of prohibited conduct. Neither of these points is valid.

a. The legislative history of the 1960 amendments does not show that either Congress or the Commission believed that the Act as it then stood did not proscribe non-disclosure by an investment adviser of his trading on the effect of his recommendations. This

history consists of statements and memoranda of Commission representatives submitted in support of the various proposed amendments to the Act, and Congressional committee reports which draw conclusions from these materials. As the dissent below pointed out, this history is at most of only slight relevance, since it consists "of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act" (R. 76) and does not reflect the views of the Congress which enacted the original legislation. See *United States* v. *The Philadelphia National Bank*, No. 83, Oct. Term, 1962, decided June 17, 1963; *Rainwater* v. *United States*, 356 U.S. 590, 593.

More specifically, neither these 1959-1960 legislative materials nor the doubts expressed by the Commission concerning the reach of the statute and the need for rule-making powers were addressed to the issue presented here—the legality of "scalping." Commission representatives testified, moreover, that in some cases failure to disclose an interest in a security might involve a fraud upon a client within the meaning of Section 206 of the Act.[16]

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[16] The majority opinion below refers (R. 68) to a Report of the Subcommittee on Legislative Oversight which indicates that the failure of an investment adviser to disclose to his clients the interest of a mutual fund, of which he was also adviser, in a security recommended by him did not violate Section 206(1) and (2) of the Act. *Independent Regulatory Commissions*, Report of the Special Subcommittee on Legislative Oversight of the Committee on Interstate and Foreign Commerce, H. Rep. No. 2711, 85th Cong., 2d Sess., pp. 53-54. But the testimony of Commission personnel, upon which the

The Commission has never taken the position that the anti-fraud provisions do not reach the scalping practices here involved, which go far beyond the mere recommendation of a security in which the adviser has an interest, since here the adviser made a practice of reaping a personal profit from trading on the market effect of his recommendations. The views expressed by the Commission in connection with the 1960 legislation concerned the need for rule-making powers to proscribe non-fraudulent practices which, in the Commission's judgment, might lead to fraud. Since scalping constitutes fraud under Section 206 (1) and (2), its illegality is unaffected by these views.

That the Commission has always so believed is borne out by its enforcement action. In 1946, the Commission acted under Section 206(2) in proceeding against scalping practices indistinguishable from those permitted by the court below. See *Securities and Exchange Commission* v. *Frank Payson Todd,* Civil No.

Report rested that conclusion, was that there was nothing wrong in such non-disclosure because the investment adviser in the particular situation did not necessarily have any personal interest in the securities owned by the mutual fund. See *Investigation of Regulatory Commissions and Agencies,* 85th Cong., 2d Sess., Part 12 (Hearings of Sept. 17, 1958), p. 4840. In reply to the question whether it was not the purpose of the Act to require full disclosure by an adviser concerning any interest it might have, directly or indirectly, in a recommended security, a member of the Commission's staff stated that "* * * failure to make such disclosure might involve a fraud upon the client within the meaning of section 206 of the act." *Id* at p. 4839.

6149 (D. Mass.).[17] Cf. *Seipel* v. *Securities and Exchange Commission*, 229 F. 2d 758 (C.A.D.C.).

b. Nor can the majority's narrow interpretation of subsections (1) and (2) be justified by the fact that 20 years later Congress gave the Commission rule-making power which concededly would authorize a rule proscribing, as a "means reasonably designed to prevent" fraud, non-disclosure of the type here involved. For proceeding under such a rule would not be an effective substitute for the application of the

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[17] In that case, the defendant admitted the allegations of the complaint and consented to the entry of an injunction. Securities and Exchange Commission Litigation Release No. 372, November 14, 1946, describes the defendant's activities as follows;

> The complaint alleged that Todd defrauded investment advisory clients in the following manner: Todd issues a weekly letter, "The New England Counsellor," in which he advises subscribers with respect to the purchase of securities. He also has certain clients who for an additional fee obtain more personalized advice, and until recently he managed a number of discretionary accounts. Todd would withhold making his recommendation to purchase specific securities for several days, during which he would purchase the security for his discretionary accounts and orally recommend its purchase to clients receiving more personalized advice. It would usually be an inactive security and, when the market had been raised by the subscribers' purchases, Todd would sell the security in his discretionary accounts, meanwhile continuing to recommend its purchase in his weekly letter.

The Commission's complaint alleged that Todd "managed a discretionary account in the name of his wife, Mary K. Todd."

The injunction was later vacated on grounds not germane here. 3 Loss, *Securities Regulation* (2d ed. 1961), 1516.

"general and flexible" anti-fraud provisions which the courts have long recognized as necessary to keep in check "the versatile inventions of fraud-doers." *Stonemets* v. *Head*, 248 Mo. 243, 154 S.W. 108, 114; and see *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795, 803 (C.A. 8), certiorari denied, 319 U.S. 767. Cf. *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 202-203; *State* v. *Whiteaker*, 118 Ore. 656, 247 Pac. 1077, 1079. If the Commission is to prevent clever operators from keeping one step ahead of the enforcement officers, it should not be limited to proceeding by rules which attempt to catalogue in advance every species of fraud. The Commission, of course, has the discretion to determine whether to proceed by rule or through *ad hoc* enforcement litigation (Cf. *Chenery* case, *supra*), and the fact that it could have acted under its rule-making power does not justify a restrictive reading of the substantive provisions it invoked in seeking an injunction.[18]

c. Finally, the fact that subsection (4) specifically prohibits "manipulative" practices does not suggest that the terms "fraud" and "deceit" in subsections (1) and (2) are to be read narrowly. For it is by no means certain that "manipulative" is any broader

[18] The Commission has promulgated two rules under Section 206(4). They make it a fraudulent, deceptive or manipulative act, practice or course of business for an investment adviser (1) to use certain advertising, or (2) to fail to follow specified procedures respecting clients' funds or securities which are in the adviser's custody or possession. 17 CFR § 275.206 (4) 1 and 2 (Cum. Supp.).

than the other two terms,[19] and it therefore does not follow that even if respondents' non-disclosure were neither fraudulent nor deceitful, it could be prohibited as "manipulative."

CONCLUSION

The judgment of the court of appeals should be reversed, and the case remanded with instructions to enter a preliminary injunction.

Respectfully submitted.

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Solicitor General.

DANIEL M. FRIEDMAN,
Assistant to the Solicitor General.

PHILIP A. LOOMIS, JR.,
General Counsel,

DAVID FERBER,
Associate General Counsel,

MICHAEL JOSEPH,
Attorney,

Securities and Exchange Commission.

JULY 1963.

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[19] See, for example, Section 15(c)(1) of the Securities Exchange Act (15 U.S.C. 78o(c)(1)) which refers to devices "as are manipulative, deceptive, or *otherwise* fraudulent" (emphasis supplied). See also *Norris & Hirshberg* v. *Securities and Exchange Commission*, *supra*, 177 F. 2d at 233. And cf. *United States* v. *Brown*, 79 F. 2d 321, 325 (C.A. 2), where in a case arising under the mail fraud statute, 18 U.S.C. 338, Judge Learned Hand explained: "Wash sales [a common form of manipulation] are a deceit, because they broadcast the fact that a buyer and a seller have agreed to exchange the shares at a published price, when they have not done so."

APPENDIX

1. The Securities Act of 1933 (48 Stat. 74, 84, 15 U.S.C. 77a, *et seq.*) provides in pertinent part:

> An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

* * * * *

FRAUDULENT INTERSTATE TRANSACTIONS

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * * * *

2. The Securities Exchange Act of 1934 (48 Stat. 881, 891, 895, as amended, 15 U.S.C. 78a, *et seq.*) provides in pertinent part:

An Act to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

* * * *

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

OVER-THE-COUNTER MARKETS

SECTION 15.

* * * *

(c) (2) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with

which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

* * * *

3. Rule 10b-5 (17 C.F.R. 240.10b-5) issued pursuant to the Securities Exchange Act of 1934 provides:

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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No. 42

IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CAPITAL GAINS RESEARCH BUREAU, INC. AND HARRY P. SCHWARZMANN,
Respondents,

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE RESPONDENTS.

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE RESPONDENTS.

Opinions Below.

The Circuit Court *en banc* held:

> "* * * There is no proof that defendants employed 'any device, scheme or artifice to defraud any client or prospective client' or engaged 'in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. * * * (306 F. 2d 606, 609.) (R. 65.)
>
> * * * * * * *
>
> "No proof having been presented under sections 206(1) and (2) sufficient to justify the granting of a preliminary injunction, the order appealed from is affirmed." (p. 611.) (R. 70.)

The District Court found there was no fraud or deceit and none was intended.

> "* * * There is no proof here that any client * * * lost a single dollar * * * or that defendants intended that any client * * * should * * *.
>
> * * * * * *
>
> "* * * there is nothing to indicate that defendants intended anything but maximum profits for their clients * * *." (191 F. Supp. 897, 899.) (R. 21.)

Statute Involved.

Preliminary injunction was sought for alleged violation of the Investment Advisers Act of 1940, Section 206, Subdivisions (1) and (2)[1] (54 Stat. 852, 15 USC 80b-6).

> "§ 80b-6. Prohibited transactions by investment advisers
>
> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> "(1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> "(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> "(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the

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[1] The Statute was amended September 6, 1960 by adding Subdivision (4) which was in effect at the time of the application for the preliminary injunction.

Penal sanctions are provided for violation (§80b-17).

capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

"(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Question Presented.[2]

Whether a preliminary injunction was properly denied for failure of proof of a "device, scheme or artifice to defraud" or a "practice * * * which operates as a fraud or deceit" upon an investment adviser's clients in violation of Section 206(1) and (2) of the Investment Advisers Act of 1940, where the honesty of the advice is unquestioned, the recommendations made in good faith, the subscribers in the instances complained of in fact had the opportunity to profit 34 to 84%, three decisions below found no proof of fraud or deceit or intent, and where the adviser, after research and deciding to recommend a stock, in some instances bought a small number of shares but did not retain them for long-term gain and did not include in his

[2] The SEC states the question presented is "scalping". This term does not appear in the moving papers and is adopted by the minority without proof. It does not appear in any law, rule, or regulation of the SEC. The term has no sinister connotation. It existed before the SEC or investment advisers. It merely describes quick trading for fractions or a point by floor traders who do not have to pay commissions and therefore can so trade. *Munn's Encyclopédia of Banking and Finance*, p. 667.

bulletin a so-called broker-dealer "disclosure clause" that he "may from time to time hold securities recommended", not knowing of any rule requiring disclosure.

Statement.

Harry P. Schwarzmann, or his company, has been a registered investment adviser since 1953. He is a man of good repute and sound business background. He left the presidency of a substantial corporation, with a salary of $72,500 a year, to organize his own business (R. 24, 26).

Capital Gains issued two publications. One, "Facts on the Funds", contained solely statistical information of portfolio changes of the leading mutual funds. It was distributed periodically to about twenty thousand subscribers for a fee of $24 per year (R. 26).

The other publication, here involved, a "Special Bulletin" or "A Capital Gains Report", was subscribed to by about five thousand at $18 per annum (R. 26, 27). This publication was issued after research of a particular stock, and management consultation, giving statistical and analytical data, and generally contained a recommendation of a stock to be purchased for long-term appreciation (R. 22, 27).

The implication of the SEC (adopted by the minority below), that bulletins were issued sometimes to one hundred thousand non-subscribers to create buying, is absolutely false (R. 27). Reason and arithmetic confirm the fallacy of the premise. The cost of issuing 100,000 bulletins (postage, printing, mailing of $7,000-$8,000) would have caused respondents a substantial loss on all but one transaction and a very considerable total loss on the combined total.

This suit was started precipitously in November, 1960, after a two-day investigation (R. 23, 24). Prior to the suit

the SEC was informed that, while Capital Gains believed it had a right to make use of its own research to trade in the open market—and had not committed any fraud or deceit—it was, nevertheless, willing to abide by any rule or regulation as to trading or make any disclosure of transactions which the SEC suggested (R. 22-24, 26). The practice complained of ceased immediately without necessity of suit, but, regardless, the SEC embarked upon this litigation now three years old.

Preliminary injunction was sought on an affidavit "on information and belief" (R. 9). Mr. Schwarzmann's answering affidavit was not replied to and stands unchallenged.

It is not disputed that the recommendations to subscribers were sound; that, in seven years as an investment adviser, Mr. Schwarzmann had never written on a questionable stock; that each recommendation was carefully selected, thoroughly researched and investigated (R. 22). All of the stocks are nationally known and listed on the New York Stock Exchange, save one on the American Stock Exchange. The reports were an unbiased and careful selection made in good faith to provide subscribers an opportunity for long-term capital appreciation (R. 22). Subscribers had, in each instance complained of, the opportunity for substantial profit, as shown in the following chart.

Name of Stock	Price When Recommended	Subsequent High	% Increase	% Profit Realized by Capital Gains on its Transactions
Continental Insurance	\$48½	\$74⅞	54.4	2.0
United Fruit	22¾	30½	34.1	8.8
Creole Petroleum	25⅝	42¾	66.8	1.0
Hart, Schaffner & Marx	23	36½	58.7	6.0
Frank G. Shattuck	17	31⅜	84.5	6.8
Union Pacific	25	37⅛	48.5	3.2

Capital Gains' purchases were made after research and after it had determined to recommend a stock for long-term appreciation.

There was nothing secret about the transactions. Stocks were openly bought and sold in the name of Capital Gains through member firms of the Exchange (R. 23). There was no proof that any subscriber did in fact purchase any stock referred to in the bulletins.

The number of shares purchased by Capital Gains was insignificant compared to the outstanding stock of the companies involved:

	Shares Purchased	Outstanding Shares
Continental Insurance	500	11,998,000
Creole Petroleum	2,000	77,621,000
Union Pacific	2,000	22,439,000
Hart, Schaffner & Marx	600	875,695
United Fruit	5,300	8,733,000
Shattuck	600	1,104,000

In two instances (Continental Insurance and Shattuck) stock was purchased after issuing the reports, as well as before (R. 28, 29).

There was no proof that the transactions of Capital Gains in any way interfered with the profit that might have been made by any subscriber who followed the recommendation.

There was no proof that Capital Gains' recommendations influenced the market; there are hundreds of investment advisers and thousands of brokers who recommend stocks. We know in one instance (Union Pacific) purchase of the stock had been recommended by Standard & Poor's, the largest nation-wide advisory service, ten days before Capital Gains' recommendations (R. 30). Three leading New York Stock Exchange houses recommended Continental Insurance after Capital Gains (R. 30).

The SEC chart (SEC brief, p. 6) is incorrect in four out of seven transactions and overstates the total profit of Capital Gains by over 90%. Their statement that their data is unchallenged ~~is~~ contrary to fact. It was and is challenged by Mr. Schwarzmann's answering affidavit which was never contradicted.

The correct figures are: The profit on Continental Insurance was $89 instead of $1,125 (R. 29); on Creole, $569 instead of $1,762 (R. 31); on Union Pacific, $1,599 instead of $1,757 (R. 31), and on Chock Full O'Nuts, a loss of over $4,000 instead of a profit of $2,772.33 (R. 29).[3]

Chock Full O'Nuts.

This transaction is charged as part of a scheme to defraud subscribers. Capital Gains never recommended the stock for purchase and had no knowledge whether any subscriber owned a single share (R. 28). It did not recommend a sale or short sale. The bulletin in question was a study of the relative values of Chock Full O'Nuts and Shattuck (Schrafft's), pointing out that at current prices there was far greater opportunity for profit in Shattuck and recommending it for purchase (R. 28, 29, 42, 43).

Mr. Schwarzmann's views were confirmed by no less an authority than William Black, President of Chock Full O'Nuts, who wrote Mr. Schwarzmann on October 19, 1960:

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[3] Among the causes of error, the SEC has failed to deduct brokerage commissions and charges, which, on the 500 shares of Continental Insurance they refer to, amounted to $465.18. In addition, they exclude the purchase of 500 shares of Continental Insurance four days after the bulletin, which they "deem inapplicable to the question in this case". It is as important as any other fact in determining intent to defraud or deceive. They further fail to account for a loss of $6,962.50 in Chock Full on options which were worthless at the time of Mr. Schwarzmann's affidavit (R. 28, 29), and at the expiration date of the options, which the SEC well knows as it is public information.

"Dear Mr. Schwarzmann:

"I read your analysis of our stock as compared with Schrafft's.

"I agree with you. Our stock is overpriced. Schrafft's is underpriced. * * *"

This letter was not made public at the hearing as the respondents feared that publicity thereof might cause a debacle in the stock and serious loss to thousands of stockholders. It was, however, presented to the SEC's attorney in the District Court on the hearing of the motion.

Capital Gains' transactions in Chock Full O'Nuts were Mr. Schwarzmann's private affair and had no relation to subscribers. It had completed transactions in the stock in July and September, 1960, long before there was any thought of writing the bulletin of October 14th (R. 28).

Summary of Argument.

A preliminary injunction was properly denied in November, 1960, for failure of proof of a "device, scheme or artifice to defraud" or a "practice * * * which operates as a fraud or deceit" upon an investment adviser's clients in violation of Section 206(1) and (2) of the Investment Advisers Act of 1940.

The decision below is not predicated upon a narrow construction of the statute, but on failure of proof. The statute having penal sanctions may not be extended beyond its terms. Three decisions have found no proof of fraud or deceit or intent and these findings, supported by the record, are unassailable under the rule of this Court.

The respondents' recommendations were for long-term gain, which, in the instances complained of, the subscribers had from 34 to 84%. The SEC contends, contrary to the

decided cases, that, regardless of honest advice and intent, because Capital Gains, after research and deciding to recommend a stock, purchased a small number of shares before issuing a bulletin and did not hold the stock for long-term gain as recommended without the bulletin containing a so-called "broker-dealer disclosure footnote" that "we may from time to time hold stocks recommended", it is a breach of fiduciary duty and fraud and deceit.

Breach of fiduciary duty is not a violation of the statute—fraud and deceit are required. The duty owed by Capital Gains was to make honest recommendations with honest intent that subscribers would have opportunity for long-term gain, which they had 100%.

The SEC has conceded that if Capital Gains had purchased and held for a long-term gain there would be no necessity of disclosure and no fraud because they were doing exactly as recommended. It cannot become fraudulent if they held for five months and 29 days instead of six months, or for any lesser period.

To constitute a fraud or deceit the non-disclosure must not only be of a material fact but with intent to deceive or defraud. The respondents' transactions were not a material fact as to whether the advice was honest or given with the intent that subscribers have the opportunity for long-term gain.

The insertion in the bulletin of the so-called "broker-dealer disclosure clause" would give subscribers no more information as to whether the recommendation for long-term profit was sound and given with honest intent than if omitted.

In the decided cases involving broker-dealers, where non-disclosure has been held material and deceitful, there was a wrongful motive and intent to deceive by non-disclosure.

On petitioner's theory it would be fraudulent for an adviser not to buy every stock recommended unless he tells subscribers that he does not follow his own advice.

The respondents' recommendations did not become "disinterested" by buying shares where their decision to recommend preceded the purchases, and the advice was honest and for the purpose of enabling subscribers to obtain long-term gain.

An investment adviser has the right to use his own work product to buy and sell in the open market, barring some regulation to the contrary.

No rule has ever been promulgated by the SEC, although it had general rule-making power since 1940 and obtained an amendment to the statute in 1960 to deal with "problems as a *material* adverse interest". (Emphasis supplied.)

There was no necessity for this suit or injunctive relief. The respondents ceased purchasing securities that were to be recommended when the SEC indicated disapproval prior to the commencement of the suit. The situation should have been treated as an administrative problem as the Commission has the power to suspend or revoke licenses. There was no abuse of discretion in denying a preliminary injunction.

The SEC has violated the law by publicizing this to be "the biggest fraud of its kind" before respondent had the opportunity to file an answering affidavit, ruining his reputation and business, and prejudicing his rights to a fair trial on the merits.

ARGUMENT.

The Decision Is Not Predicated on a Narrow Construction of the Statute but on Failure of Proof.

The decision below is not based upon a narrow construction of the statute but solely upon a failure of proof of fraud or deceit. The Court held nothing more.

The statute, having criminal sanctions (80b-17) making a violation a felony, may not be extended beyond its terms. *United States* v. *Resnick,* 299 US 207, 210 (1936); cf. *Barber* v. *Gonzales,* 347 US 637, 642 (1954); *Blau* v. *Lehman,* 368 US 403 (1962).

This rule is applicable in civil cases involving a penal statute. There cannot be one construction for the SEC and another for the Department of Justice.

In *Federal Communications Commission* v. *American Broadcasting Co., Inc.,* 347 US 284, 296 (1954), a civil case for an injunction, this Court held:

> "It is true, as contended by the Commission, that these are not criminal cases, but it is a criminal statute that we must interpret. There cannot be one construction for the Federal Communications Commission and another for the Department of Justice. If we should give §1304 the broad construction urged by the Commission, the same construction would likewise apply in criminal cases. We do not believe this construction can be sustained. Not only does it lack support in the decided cases, judicial and administrative, but also it would do violence to the well-established principle that penal statutes are to be construed strictly."

The elements of fraud and deceit are well established.[4]

Fraud is never to be presumed and must be established by clear, convincing, and satisfactory proof.[5]

Intent to defraud or deceive is a necessary ingredient of a violation of the statute. *Durland* v. *United States,* 161 US 306, 313, 314 (1896); *United States* v. *Brandt,* 196 F. 2d 653, 657 (2d, 1952); *Troutman* v. *United States,* 100 F. 2d 628, 632 (10th, 1938); cert. den. 306 US 649[6]; *Rice* v. *United States,* 149 F. 2d 601, 603 (10th, 1945).[6]

The decision below does not conflict with any cases cited by SEC under other statutes[7]. These four cases involved a review of SEC orders revoking broker-dealer licenses. In each case unlisted securities were sold to customers at far in excess of the market price and in some instances the market was controlled by the defendants. Fraud and deceit were clearly established.

In *Securities and Exchange Commission* v. *Torr,* 87 F. 2d 446 (2d, 1937), the defendants were seeking to unload over 47,000 shares of stock and engaged a nationwide crew

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[4] *Hackner* v. *Morgan,* 130 F. 2d 300, 302 (2d, 1942); *United States* v. *Brown,* 79 F. 2d 321, 325 (2d, 1935).

[5] *United States* v. *Thompson,* 279 F. 2d 165, 167 (10th, 1960); *Equitable Life Insurance Co. of Iowa* v. *Halsey, Stuart & Co.,* 112 F. 2d 302, 308 (7th, 1940).

[6] These cases involved fraud provisions of the Securities Act of 1933, 15 USC 77q.

[7] *Charles Hughes & Co.* v. *Securities and Exchange Commission,* 139 F. 2d 434 (2d, 1943); cert. den. 321 US 786; *Norris & Hirshberg* v. *Securities and Exchange Commission,* 177 F. 2d 228 (CA, DC, 1949); *Archer* v. *Securities and Exchange Commission,* 133 F. 2d 795 (8th, 1943); cert. den. 319 US 767. In *Hughes* (Arleen) v. *Securities and Exchange Commission,* 174 F. 2d 969 (CA, DC, 1949) her investment adviser registration was not attacked but solely her broker-dealer registration. She was readmitted to registration as a broker-dealer, 30 SEC 390 (1949).

to recommend the stock so the defendants could unload. The fraud and deceit were apparent.

In *Ridgely* v. *Keene*, 134 App. Div. 647; 119 NYS 451 (2d Dept.) an adviser was engaged by stock brokers for compensation to recommend a stock in which the brokers had a pool and were seeking to raise the price and unload. There was palpable fraud.

In *Securities and Exchange Commission* v. *Frank Payson Todd*, Civil No. 6149 (D. Mass.), the defendant consented to an injunction which was vacated without objection of the SEC to permit a trial on the merits and the SEC eventually agreed to a dismissal as it appeared that the facts would not support an injunction[8].

Todd had been recommending to one group of clients to buy stock and, at the same time, selling out the stock in another group of clients' accounts.

The SEC, however, contends contrary to the decided cases that intent is immaterial[9].

The SEC further maintains that a breach of fiduciary duty is a violation of the statute, but, on the contrary, a violation requires fraud or deceit. A violation of a fiduciary duty may not be fraudulent.

There was not only no fraud or deceit but no breach of fiduciary duty.

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[8] *Loos Securities Regulation*, Vol. III, 2d ed., p. 1516.

[9] SEC brief, p. 11: "It is immaterial that respondents may have believed in the soundness of their recommendations or made them without conscious intent to advance their personal trading interests."

Similarly, brief, p. 18.

There was no proof of fraud or deceit.

The soundness of Capital Gains' recommendations is not questioned. Two courts have found that Capital Gains intended subscribers to have maximum profits. In fact, in the instances complained of, subscribers had the opportunity of long-term gain of from 34-84%.

The SEC contends that, regardless of Mr. Schwarzmann's honest reports and good intent, because Capital Gains, after completing its research and after deciding to recommend a stock, purchased a small amount of stock before issuing the bulletin and sold the stock from five to fourteen days thereafter without the bulletin containing a so-called broker-dealer disclosure footnote, such as "we may or may not hold the stocks recommended," a fraud and deceit has been perpetrated on subscribers.

The integrity of the recommendation is not altered because Capital Gains bought some shares after its decision to recommend but before the bulletin. Nor does the advice become disinterested because of the purchase. The recommendation would have been made regardless.

The suggestion that respondents' recommendation may have been motivated because of his small purchases and small profit is contrary to and a distortion of the facts. The advice was given in the course of business in the belief that subscribers would have long-term appreciation, which proved 100% correct. Capital Gains was contractually obligated to issue bulletins and the success of the business depended on the correctness of the advice.

Petitioner's indication (brief, p. 12) that respondents had a $90,000 a year business and made $20,000 in market profits is contrary to the facts. Capital Gains' gross from its publications was $570,000 a year (R. 25, 26, 27) and its

profits on the transactions were about half that claimed by the SEC, or about $10,000 (R. 28-32).

It defies common sense to believe a man who spent seven years to build up a business with a gross of over half a million dollars a year would endanger that business for an extra profit of $10,000 if he had any reason to believe that he was doing something wrong. It is more incredible to believe he was issuing bulletins so he could make small market profits instead of developing the further growth of the business.

The SEC (brief, p. 9) misquotes the opinion below by omitting "tends". The opinion said "the SEC's proof *tends* only to show that, at most * * * Schwarzmann profited personally from the predictable market effect of his honest advice" (R. 65). (Emphasis supplied.)

There was no proof but surmise that the bulletins moved stock issues with millions of shares, one with 77,000,000 (*supra* p. 6). Other advisory services and brokers recommended some of the issues (R. 30, 31, 32) and there are thousands of brokers who could have been recommending them at the same time. Nor was there any proof that any subscriber did in fact purchase. In one instance subscribers were told not to be in haste to buy so as not to disturb the market (R. 32, 41). Nor were the profits "predictable", as witness the loss of $6,962.50 on the Chock Full options, which were completely worthless (R. 29).

An investment adviser has the right to use his own work product to buy and sell in the open market, barring some regulation to the contrary. No regulation as to trading or the manner or extent of disclosure was ever promulgated, although the SEC had general rule-making power under the Act since 1940 (§ 80b-11) and was directed to make rules under the 1960 amendment (§ 80b-6(4)). Common sense

would dictate that a subscriber would expect an adviser to do so. The statute (§80b-6(3)) contemplates that an adviser would trade and contains the only provision for disclosure, i.e., when an adviser sells directly to a subscriber.

The adviser's purchases were not contrary to his recommendation to purchase for long-term gain. If he purchased none, on petitioner's theory, an adviser might be guilty of deceit by not disclosing that he did not follow his own advice.

The point of departure here is that although the adviser purchased he did not hold for a long-term gain. There is neither legal nor moral obligation that an adviser buy every stock he recommends and hold it for as long as he recommends at the peril of being accused of fraud.

It has been conceded that it would not be fraud for an adviser to buy and hold for a long-term gain as recommended, i.e., for six months, without disclosure.

Does it turn fraudulent if the adviser buys but holds for five months and 29 days instead of six months? Or if he holds only for four months, two months, one month, or ten days? Obviously not! The crucial test is, was the advice honest and given in good faith with honest intent that subscribers have the opportunity for long-term gain.

The respondents' transactions were not a material fact as to whether the advice was honest and with good intent or that subscribers could have an opportunity for long-term profit therefrom.

The accepted form of disclosure of broker-dealers for over twenty years, that they "may from time to time hold a position in the securities mentioned", cannot be the difference between integrity and fraud. This uninformative phrase which the SEC considers sanctifying for broker-dealers, is worship of "disclosure" as a shibboleth—of form to substance.

No disclosure can make a dishonest transaction honest, nor lack of disclosure make an honest one dishonest.[10]

The non-disclosure, to constitute fraud, must not only be as to a material fact but it must be with intent to deceive.[11]

The inclusion of the standard broker-dealer "disclosure clause" in a bulletin would give the subscribers no more information as to whether the recommendation for long-term profit was sound and with honest intent than if omitted. The omission constituted no deceit and surely was with no intent to deceive.

There is no element of manipulation involved. There was no proof that respondents' transactions interfered with or were adverse to subscribers' opportunity for long-term gain. There was no proof that the reports in fact influenced the market,[12] but, assuming they had, a correct report issued in the course of business that a stock is undervalued, even if it causes the market to rise, is not manipulative. "Manipulation" means to artificially raise prices.[13] In any event, the manipulation would have to be one that deceived or defrauded the subscriber, which is patently not the case.

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[10] *Epstein v. United States*, 174 F. 2d 754, 768 (6th, 1949).

[11] *Otis & Co. v. Securities and Exchange Commission*, 106 F. 2d 579, 582 (6th, 1939).

[12] The SEC brief (footnote 5, p. 15) now tries to supply inferential proof, not part of the record nor competent evidence, and not dealing with the facts.

[13] Securities Exchange Act, 15 USC 78i, j, and rules thereunder.

There Was No Breach of Fiduciary Duty.

The SEC contends that a breach of fiduciary duty is a violation of the statute.

> "* * * But to say that a man is a fiduciary only begins analysis; * * * What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" *Securities and Exchange Commission* v. *Chenery Corp.*, 318 US 80, 85, 86 (1943).

The obligations respondents owed to subscribers was to give honest advice with honest intent that subscribers would have the opportunity for long-term capital appreciation. This obligation was fulfilled 100% and was in no wise impaired by the adviser making a profit on his own research in a manner which in no way interfered with the subscriber's possibilities for long-term appreciation. The adviser's transactions were his private affair and did not alter the integrity of his advice or his good intent; nor did the omission of a so-called broker-dealer "disclosure clause".

But breach of duty is not a violation of the statute—the test is fraud or deceit.

> "* * * Whether a breach of trust is an active fraud depends upon what the particular breach of trust consists of * * *." *Epstein, supra,* p. 766.

United States v. *Buckner,* 108 F. 2d 921, 926 (2d 1940), cited by the SEC, is not contrary; there was "an active fraud".

There was no breach of fiduciary duty and the finding in three decisions below of no fraud and deceit upon which to predicate a preliminary injunction was clearly sup-

ported by the record and is held unassailable under the rule of this Court[14].

There Was No Abuse of Discretion in Denying the Preliminary Injunction.

In reviewing the denial of a preliminary injunction, the question is whether the denial was an abuse of discretion. Discretion is implicit in the decision even if not expressed.[15] The ultimate merits are not at issue.[16]

Not only was there failure of proof but the suit and preliminary injunction were unnecessary.

Prior to the commencement of the suit in November, 1960, when the transactions were questioned, respondents, while asserting no fraud or deceit had been perpetrated, were willing to abide by any suggested practice as to trading or not trading or a disclosure thereof that the SEC deemed advisable (R. 22, 26, 32).

Instead of handling the situation as an administrative matter (the Commission has the right to revoke an adviser's registration (15 USC 80b-3(d)), since the practice complained of had ceased, the Commission, nevertheless, on a two-day investigation, embarked upon this litigation.

An injunction is not justified by the fact that a defendant is in a position to commit a violation or that plaintiff thinks he might.[17]

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[14] *Comstock* v. *Group of Institutional Investors,* 335 US 211, 214 (1948); *Alabama Power Co.* v. *Ickes,* 302 US 464, 477 (1938).

[15] *United States* v. *Corrick,* 298 US 435, 437, 438 (1936).

[16] *Alabama* v. *United States,* 279 US 229, 231 (1929); *Meccano, Ltd.* v. *John Wanamaker,* 253 US 136, 141, 142 (1920).

[17] *United States* v. *U. S. Steel Corp.,* 251 US 417, 445 (1920); *Securities and Exchange Commission* v. *Torr,* 87 F. 2d 446 (2d, 1937).

Nor should a preliminary injunction be granted where its effect is to give final relief before a trial of the issues.[18]

The litigation is nigh three years old and the Commission is still seeking a preliminary injunction, making no effort to proceed on the merits. Petitioner does not deny that the acts complained of ceased three years ago.

The purpose of injunctive relief is not to punish for past acts, assuming they were unlawful, but in a proper case to prevent future violations.[19] When the acts complained of have ceased there is no reason for the suit or for injunction, no triable issue, and the case is moot.[20]

This Court does not review the right to a preliminary injunction where the necessity for relief does not exist[21]

Petitioner Has Unlawfully Used Publicity to Destroy Respondents' Business and Reputation.

The traditional rules of equity apply to actions involving Governmental agencies.[22] A seeker of equity must do equity.

The day after this action was commenced in November, 1960, not content with publicizing information contained in the moving papers, there appeared in the public press:

> "According to Henry B. Bright of New York, senior attorney for the SEC, who brought the complaint against Schwarzmann, 'this is the biggest

[18] *Securities and Exchange Commission* v. *Torr, supra; United States* v. *Adler's Creamery,* 107 F. 2d 987, 990 (2d, 1939); cert. den. 311 US 657.

[19] *Hecht Co.* v. *Bowles,* 321 US 321, 329 (1944); *Walling* v. *T. Buettner & Co.,* 133 F. 2d 306 (7th, 1943).

[20] *Walling* v. *Shenandoah-Dives Mining Co.,* 134 F. 2d 395 (10th, 1943).

[21] *United States* v. *Alaska S.S. Co.,* 253 US 113, 116 (1920).

[22] *Alabama* v. *United States, supra,* p. 230.

fraud of its kind which we have discovered on the market in the last 10 years.' " (R. 25.)

This was before respondents had an opportunity to file an answering affidavit, which has never been contradicted.

Such publicity is forbidden by the Investment Advisers Act (80b-10(b)) which provides the Commission or employee "shall not make public * * * the results of or any facts ascertained during any such * * * investigation".[28]

Despite these clearly defined restrictions on publicity, designed and spelled out to protect innocent people, to prevent the destroying of reputation and creating prejudice to a fair hearing, other statements not appearing in the moving papers appeared in the public press emanating from petitioner's office (R. 25). Such publicity is in violation of Canon 20 of the American Bar Association Canons of Professional Ethics, proscribing trying cases in the newspaper to the prejudice of respondent's rights and the administration of justice.

The 1960 Amendment Was to Enable the SEC to Deal with "Material Adverse Interests" of Investment Advisers.

In 1960 the Investment Advisers Act was amended by adding to Section 206 Subdivision (4). This amendment was sought by the SEC for the purpose of enabling it to deal with "such problems as a *material* adverse interest in securities which the adviser is recommending to his clients" (R. 69, 70).

To obtain the amendment, SEC representatives testified before a Congressional subcommittee that an investment

[28] The restriction on publicity may explain the resort to court action instead of the use of completely adequate administrative procedures provided by the Act (§80b-3(d)).

adviser who recommended an issue of debentures of an affiliate was not required to disclose its financial interest (R. 68, 69).

In sharp contrast they now argue (brief, p. 10) that an adviser must render "completely disinterested advice" and yet concede that there are situations "where there may be no need of disclosure of the adviser's interest" (brief, p. 13).

Here the adviser's purchases were not adverse to, nor did they in any way interfere with, the subscribers' opportunity for long-term gain.

The SEC has had general rule-making power for over twenty years, and sought the 1960 amendment of the statute to obtain specific rule-making power to deal with problems of "material adverse interests," and yet has made no rules dealing with this problem which might serve as a guide to the industry. It would seem that justice and fair play would require that they do this and that they handle situations such as this present case in administrative proceedings before they embark in litigation accusing someone of fraud and deceit.

Conclusion.

The judgment of the Court of Appeals should be affirmed or the writ dismissed.

Respectfully submitted,

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